**Before the**
**FEDERAL COMMUNICATIONS COMMISSION**
**Washington, DC 20554**

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|---|---|---|
| In the Matter of | ) | |
| | ) | |
| Unbundled Access to Network Elements | ) | WC Docket No. 04-313 |
| | ) | |
| Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers | ) ) ) | CC Docket No. 01-338 |

# COMMENTS OF ACN COMMUNICATION SERVICES, INC.


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October 4, 2004

## SUMMARY

To preserve competition for local residential phone service, it is imperative that the Commission preserve access to unbundled mass market switching. Unlike urban and business customers, residential and non-urban markets are characterized by poor economies of scale and scope, making it difficult, if not impossible, for a facilities-based competitor to justify the investment in the residential market. ACN has investigated a number of alternatives to residential UNE-P, including resale, self-provisioning, third party switching, alternative technologies (e.g. VoIP) and ILEC wholesale agreements, and found none of them to be economically viable, at this time, in ACN's target markets.

Absence of UNE-P will be detrimental to the public interest, because lack of competition in this market will result in higher rates and fewer services for the vast majority of telecommunications customers. Moreover, while BOC's may suffer from a frustration of their expectations, they are not harmed by TELRIC rates, which contribute to overall revenues and are offset by revenues from advanced services and long distance services, approval for which was conditioned on the presence of adequate competition. Without UNE-P, this competition cannot be preserved in residential markets.

The mandate from the USTA II court does not require the Commission to eliminate UNE-P; rather, the Commission is directed to provide more support for its original impairment determination. Ample evidence exists to support continued unbundling of mass market switching, particularly in residential and non-urban markets. ACN proposes that the Commission adopt an impairment standard that uses a line-density analysis, applied on an individual carrier basis, that will establish the threshold at which a carrier is no longer impaired without access to unbundled mass market switching. This is an easily administered standard that

recognizes practical investment concerns and conforms to the Commission's current impairment considerations, especially in regard to economies of scale, sunk costs, and first mover advantages.

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## COMMENTS OF ACN COMMUNICATION SERVICES, INC.

In response to the Commission's Notice of Public Rule Making in the above captioned proceedings, ACN hereby comments on the criteria for an impairment finding for unbundled switching and asks that this criteria take into consideration the difference between CLECs with predominately residential versus commercial customers, requests continuation of UNE-P under section 251 and 252 of the Telecom Act of 1996, and requests that these permanent rules be established with such speed that would prevent the harm to consumers that would come as a result of extinguishing the interim rules.

ACN Communication Services, Inc. ("ACN") is a privately held Michigan company that has provided resold telecommunication services for over 12 years. It has a national sales force located in every state, and in every zone where local services can be sold. ACN began offering local service in January 2003 and currently sells local service bundled with long distance, international calling, internet access, and DSL. This local bundled service is provided to approximately 175,000 customer lines in 30 markets in 27 states, including rural zones, where cost effective. Due to the present uncertainty that exists for competitive local service providers, ACN has discontinued expansion of its local service to new markets. This has deprived residential consumers in metropolitan and non-metropolitan areas of an alternative to the higher priced services currently featured by the ILEC's. ACN originally planned to launch its residential service in 15 additional states this year, bringing service to consumers in a total of 42 states as well as an additional 10 markets for small commercial customers. ACN has reduced workforce as a result of this change in direction, and sales agents lose the opportunity to make a living by selling local bundled service in these states.

This is unfortunate, since ACN is precisely the kind of competitive telecommunications carrier that was envisioned by the Telecom Act of 1996. ACN does not target high margin, multi-line commercial customers. In fact, 99.7% of ACN's local service customer base is residential, with an average of 1.07 lines per household. 70 % of ACN's customers live outside metropolitan zones. 35% of ACN's customers live in rural zones (in New York, over 60% of ACN's customers are in rural zones). This proportion is especially high, considering that ACN is only able to offer local service in Zone 3 (and above) in 18 of the 27 states in which it operates. It is, unfortunately, cost-prohibitive to provide service in rural zones in the remaining states.

Thanks to TELRIC based UNE-P service, ACN has been able to offer diverse, competitively priced and affordable products to residential customers in locations where they would otherwise have had no choice in local service provider. If UNE-P is eliminated or significantly increased in price, ACN will no longer be able to offer robust, affordable products to those customers who are least likely to have a choice of providers.

## I. THERE ARE NO COST EFFCTIVE ALTERNATIVES TO UNBUNDLED SWITCHING IN THE MARKET ACN SERVES

In response to the Triennial Review Order and the USTA II decision, ACN has explored a number of alternatives to UNE-P, with unrewarding results. These alternatives, which are discussed more thoroughly below, include:

- Total service resale
- Self Provisioned facility-based services
- Third party wholesale facility-based services
- "Commercial" agreements with ILEC's
- Alternative technologies (e.g. VOIP)

### A. Total Service Resale

ACN has carefully reviewed the resale of already-packaged services as an alternative and found it wholly unworkable for its target markets. One of the most significant problems with resale is that the reseller's offerings are limited to the ILEC's retail plans. ACN's products would therefore be limited to a set of services chosen by the ILEC. ACN would have no ability to provide creatively bundled, cost effective solutions for end-user customers, which is what true competition demands. Furthermore, promotional products are not required to be offered for resale, and the ILEC can eliminate existing products at any time. ACN and its customers become subject to the whim of CLEC product changes.[1] If a customer decides to make a change to a service/product grandfathered by the ILEC, they lose that service.

Profit margins are even more of a problem. In the states that ACN serves, resale discounts offered to carriers such as ACN range from a low of 12% to a high of 23.43%, with an average discount rate across 27 states and 30 markets of approximately 17%. Given an average

[1] *See, e.g* "Grandfathering of Products – PA," Verizon Industry Letter, Oct. 1, 2004, attached hereto as Exhibit 1 (also found at <http://www22.verizon.com/wholesale/library/local/industryletters/1,,east-wholesale-resources-2004_industry_letters-clecs-10_01e,00.html>).

local customer retail price of $30, and assuming that ACN charged the same, this 17% discount would yield $5.10 – not nearly enough to cover bad debt, sales, general, and administrative costs of servicing a retail customer and still produce a profit. To make matters worse, resellers cannot offset these losses with access charge revenues, since these accrue to the ILEC, not the reseller. Resale might possibly be viable for commercial accounts, where usage charges and monthly line charges are higher, but it is not an option for CLECs who provide service to mainly residential customers.

### B. Self Provisioned Facility-Based Services

Although ACN would prefer to be independent of the ILECs, deployment of switching facilities is not a current viable option for ACN. ACN serves its customers from almost 5,000 wire centers, with an average of only 32 lines per central office. After reviewing the projected costs of deploying its own switches into the network, ACN has concluded that it currently does not have sufficient line density in any one location to recover the sunk costs of collocation and switch deployment and still achieve a return on its investment.[2]

ACN has reviewed industry analyses of the line density required in a CO to justify the investment in switching facilities. There are a wide variety of variables and assumptions that go into these analyses, and we have studied an even wider array of resultant estimates of break-even line density. None of the analyses we have conducted on our own or studied suggest that ACN has achieved line density anywhere close to that needed to justify its own facilities. ACN has 20 or fewer customer lines in 64% of its serving wire centers, and 100 or fewer lines in 93% of serving wire centers. The 1996 Telecom Act envisioned a competitive environment whereby an

[2] These calculations do not incorporate the cost of "hot cutting" customers, which may further limit when and where ACN could bring customers onto its own network.

entrant like ACN could build its customer base and line density to a sufficient point where deployment of its own facilities would be justified. ACN has not yet achieved that density. Further increases to UNE-P expenses, or the elimination of unbundled switching would stymie ACN's efforts to achieve objectives of the Telecom Act.

Even if ACN were to achieve a penetration rate large enough to justify self provisioning of facilities and equipment, the economics involved would limit the extent to which it could deploy facility-based services for residential customers. Without UNE-P, ACN would be forced to pick a few top MSAs that offer a large enough population of potential customers to begin creating a network – most likely the same MSAs that other CLECs would target, since they are governed by similar economic considerations. This would leave no competitive choice for a majority of ACN's current customer base, who reside outside of the top10 MSAs.

**C. Third Party Wholesale Facility-Based Services**

Since ACN is not in a position to deploy its own switches in its network at this time, it has looked for wholesale switching providers as an alternative to the ILEC's service. This search has been unfruitful. ACN has found that there are no companies currently offering a wholesale switching service geared to residential customers. XO Communications reviewed its Wholesale Local Service offer with ACN on August 10, 2004. This is service is not available for accounts with fewer than 6 POTS lines. MCI provided a summary of its Local Wholesale Dialtone products on August 17, 2004. This service is only T1 and above, and it is not for residential applications.

ACN intends to continue to analyze the viability of building a network where line density justifies the investment and also continue to look at potential providers of these services, particularly those who are using VoIP switches that have the potential for cost effectively bundling data and voice services to residential customers. However, these solutions will continue to be limited by line densities in a particular wire center and the existing 'footprint' of an alternative carrier. There will continue to be a need to cost-effectively provide service to residential customers in non-metropolitan zones. Consequently, it appears unlikely that ACN will be able to migrate its network to a third party switching platform in the near term, and even then there will be considerable time and expense involved in finding vendors and initiating service with them.

ACN recognizes that technology is progressing to a point where line densities required to justify collocations are decreasing, but this technology is still evolving and not fully deployed. For the next few years, there will continue to be a need to cost-effectively provide service to residential customers, especially in non-metropolitan zones.

### D. "Commercial" Agreements With ILEC's

As a matter of form, the Commission, as well as the telecommunications industry in general, should be wary of accepting the terms "commercial agreement" or "market based rates" into the vernacular, since they are neither, at least in the context of ACN's negotiations with the RBOCs. For example, a "commercial" negotiation implies the give-and-take interaction between two parties that are interested, if not eager, to reach an agreement and who are willing to make mutual concessions to fashion an agreement that addresses their individual requirements and goals. ACN's interactions with the RBOCs have proved to be nothing like this. Instead, the RBOC proposals tend to be single iteration, take-it-or-leave-it offers reflecting, at best, an ambivalence by the BOCs and, at worst, a cavalier attitude that the BOCs are in no way obligated to provide any of the bargained-for services, either under the Section 271 checklist, Section 201 and 202 common carrier obligations, or under any type of "essential facilities" doctrine, nor are they answerable to any regulatory authority regarding the rates and terms of such agreements. This is hardly the typical picture of a "commercial" arrangement.

It is equally misleading to refer to these agreements as "market based" agreements, as BellSouth likes to call them. In economic theory, the concept of a "market" implies a forum of many willing buyers and willing sellers, where the price of a good is bid up or down based on principles of supply and demand. However, where there is only one supplier of the good (e.g. unbundled residential switching), it is a misnomer to label the unilaterally set (and non-negotiable) rate as "market based."

As far as the RBOCs are concerned, ACN prefers to regard these agreements as "Section 271 agreements," since, as the following paragraphs relate, they appear to offer no more than the BOCs are obligated to provide under that section. Results of ACN's negotiations to date have been mixed.

ACN is close to accepting an offer from one ILEC. A second ILEC has been particularly puzzling in its negotiations, and in its actions outside of negotiations. On the one hand it is offering ACN a commercial agreement with additive rates in addition to loop, port, usage and other expenses. It's negotiators express their desire to retain ACN as a wholesale customer on their local switches. Then, in the next breath, they say that it is their intention to deploy packet switches throughout their network, and that they do not intend to make switching services available to wholesale customers on their packet switches, effectively eliminating ACN's ability to service its customers (other than via resale) on its packet switches.

With a third ILEC, ACN's repeated requests for negotiations have fallen on deaf ears since the ILEC's initial take-it-or-leave-it offer that would have increased rates by approximately 30%. ACN has had some substantive conversations with a fourth ILEC, but to date its conversations have not been fruitful in producing wholesale pricing that would enable ACN to continue to provide service to its customers in its service areas.

### E. Alternative Technologies

ACN is aggressively pursuing VoIP as an alternative technology for offering local service. Substantive conversations have been held with Level 3 and Primus. While we expect VoIP to be an excellent alternate service for many customers, this is not a viable alternative to UNE-P today.

VoIP is in its infancy from both a deployment and a technology standpoint, available to less than 30% of households today, and in actual use by far fewer than that. Projection are for VOIP to reach 1 million lines by the end of 2004, but it will be another four years for VOIP lines to equal the current penetration of UNE-P of 17 million lines.[3] Currently, however, the technology itself has limitations, especially quality issues associated with latency and 911.

## II. ILEC'S COST BASED PRICING ARGUMENTS IN LIGHT OF THE FACTS

ILEC arguments that intermodal competition provides sufficient variety and alternatives to unbundling are a stretch in regard to residential service.[4] For example, SBC has stated that the average rate for a UNE-P line is $15.[5] However, on average, ACN pays the ILECs over $21 per

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[3] "The Yankee Group Expects the Consumer Local VoIP Industry to Grow More Than 100 Times Its 2003 Size," News Release, Aug. 30, 2004, attached hereto as Exhibit 2 (also available at http://www.yankeegroup.com/public/news_releases/news_release_detail.jsp?ID=PressReleases/news_08302004_cts.htm>).

[4] SBC has gone so far as to assert that Instant Messaging and Email are current replacements for landline service. This is like arguing that walking and bicycling are intermodal alternatives to airlines. *See* "For Good Jobs and a Strong Economy" at 2 (SBC - Michigan lobbying pamphlet)(attached hereto as Exhibit 3).

[5] *Id.*

line when calculating all the costs that are charged by the ILEC (loop, port, usage, DUF records and other monthly charges).

SBC has also claimed that due to the “low” UNE-P rates, CLECs make nearly 70% in gross margins (SBC claims that CLECs mark up the price by 228% equating to a 69.4% Gross Margin percentage).[6] This is misleading, at best. Using UNE-P, the gross margin that ACN generates on local service are slightly more than ½ of what they claim. In deriving their unrealistic margins approaching 70%, SBC has conveniently omitted 2 important numbers:

- the local switching usage, daily usage files, and other monthly charges paid to SBC; and

- while including the long distance revenues in its total revenue analysis, SBC has failed to account for the costs of providing the long distance service.

This last oversight is surprising, since ILECs have become some of the largest long distance providers in the US. Indeed, total ILEC long distance service is in excess of 44 million lines broken down as follows:

SBC – 18.4 million lines[7]
Verizon – 16.8 million lines[8]
Bell South – 5.1 million lines[9]
Qwest – 4.1 million lines[10]

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[6] *Id.*

[7] *See* SBC Communications, Inc., June 2004 Form 10-Q Report, Selected Financial And Operating Data (Aug. 4, 2004)(available at http://www.sec.gov/Archives/edgar/data/732717/000073271704000525/q204.htm).

[8] *See* Verizon Communications, Inc., June 2004 Form 10-Q Report 26 (Aug. 6, 2004)(available at < http://www.sec.gov/Archives/edgar/data/732712/000119312504134114/d10q.htm >).

[9] *See* BellSouth Inc., June 2004 Form 10-Q Report, Management's Discussion and Analysis of Financial Condition and Results of Operations – Communications Group (July 29, 2004) (available at <http://www.sec.gov/Archives/edgar/data/732713/000073271304000211/q20410q.txt >).

Compare these numbers to AT&T, the largest provider with 29.1 million lines.[11]

In contrast to the ILEC's 44 million long distance lines, UNE-P lines serviced by CLEC's are only 17 million lines,[12] and the growth in this disparity is accelerating. In the first quarter of 2004, the ILECs gained 8 long distance lines for every 1 line that they lost to UNE-P.[13] It should be noted here that the ILECs are achieving this growth without having to build their own infrastructure, nor has this growth come by providing customers with a competitive alternative outside the boundaries of the ILECs service areas.[14]

Moreover, the RBOCs quarterly reports show that the revenue from long distance has more than offset the loss from UNE-P. An analysis of the RBOC Forms 10-Q indicate that they earn at least $700 million per month from long distance services.[15] As the following table

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[10] *See* Qwest Second Quarter Financials, Attachment D Line 30 (available at <http://media.corporate-ir.net/media_files/NYS/q/reports/2Q04_Attachments_ABCD.xls>).

[11] AT&T June 2004 Form 10-Q Report 27 (Aug. 3, 2004)(available at http://www.sec.gov/Archives/edgar/data/5907/000095012304009186/y99567e10vq.txt).

[12] *See* "Restoring the Promise of Local Competition" at 2, CompTel/ASCENT, attached hereto as Exhibit 4 (also available at http://www.comptelascent.org/public-policy/position-papers/documents/ 271socialcontract_wp_july12_2004.pdf).

[13] *See* Quarterly Reports of BellSouth, Qwest, SBC and Verizon.

[14] "Keiko Harvey, senior vice president for Verizon Advanced Services said, 'Partners like Williams Communications help us offer high-quality long-distance services, and at the same time use the most economical means to expand our network.'" Williams Communications to Provide Verizon with Domestic Long-Distance Services, News Release, Feb. 5, 2002. (available at <http://www.wiltel.com/overview/content/pressreleases/2002/02-05.htm.>).

[15] *See* Quarterly Reports of Qwest, SBC and Verizon. (BellSouth does not break out its long distance revenues, so they are not included in this figure.)

shows, this more than offsets the loss of $255 million in revenue per month resulting from UNE-P ($36 local revenue per line/month[16] less $21 per line/month collected for UNE-P).

| | **Lines Change** | **Revenue Change** |
|---|---|---|
| Est. gain from LD | 39.3 million lines gained | $703 Million/mo. |
| Est. loss from UNE-P $36/line-$21/line=$15/line (Retail Rev.minus UNE-P Rev.) | 15 million lines lost | $225 Million/mo. |
| **Net Gain** | **24.3 million lines** | **$478 Million/mo.** |

ILECs still earn revenue, albeit not as much as they would like, on the UNE-P lines that they have “lost” to competition. Long distance providers, on the other hand, do not receive any revenue for the lines that they have “lost” to the ILECs.) In addition, Verizon and BellSouth have stated that they expect to “win-back” as much as 80% of the current UNE-P lines that are serviced by CLECs, once competition is eliminated.[17]

The truth is that the ILEC’s receive substantial income from UNE-P and whatever losses in revenue they may have incurred are more than offset by income realized as a result of the long distance service they provide. TELRIC is not a new pricing model, and the pricing set forth via this pricing model reflects actual costs to operate network; not the forward looking hypothetical costs that ILEC’s use to back up their assertion that they lose money on UNE-P lines.[18] TELRIC has received the blessing of the U.S. Supreme Court, which in a May 2002 decision rejected an

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[16] “Trends in Telephone Service” Table 3.2, F.C.C. 2004 Report (May 2004)(available at < http://www.fcc.gov/wcb/iatd/trends.html>).

[17] Justin Hyde, *Baby Bells See Rivals Taking Fewer Phones*, Reuters, Sept. 9, 2004, attached hereto as Exhibit 5 (available at <http://biz.yahoo.com/rb/040909/telecoms_competition_1.html>).

[18] “The Truth About RBOC UNE-P Costs,” CompTel/ASCENT, attached hereto as Exhibit 6.

RBOC challenge.  The Court called the state rate-setting process "smooth-running affairs"[19] and said that the Bell's proposed embedded-cost pricing method would enable the RBOCS to saddle consumers with inefficiencies "caused by poor managmenet…or poor investment strategies."[20] ILECs state that the current UNE-P costs are below their true costs. However, they continue to offer retail rates below what ACN pays under UNE-P.[21]

## III. THE COMMISSION HAS AMPLE CAUSE TO CONTINUE TO UNBUNDLE MASS MARKET SWITCHING

While USTA II's vacatur of the mass market switching rules may have appealed to the inclinations of the BOCs and certain Commissioners, it cannot be emphasized more strongly that USTA II did not find unbundled mass market switching to be inherently unlawful or antithetical to the goals of the Act.  USTA II merely disapproved of the Commission's overly broad "non-provisional national impairment finding"[22] and the sub-delegation of local non-impairment determinations.

Indeed, the court threw out a few lifelines to preserve unbundled mass market switching. For example, it suggested that impairment determinations could be based on the ILEC's track record for speed and volume in a market, integrated with some projection of the demand increase that would result from withholding of switches as UNEs.[23]  It also accepted the ILECs' own

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[19] Verizon Communications Inc. v. FCC, 535 U.S. 467, 522 (2002).

[20] *Id.* at 511.

[21] SBC News Bulletin, attached hereto as Exhibit 7.

[22] United States Telecom Association v. F.C.C., 359 F.3d 554, 569 (2004)(*USTA II*).

[23] *USTA II*, 359 F.3d at 570.

suggestion that the Commission consider "rolling" hot cuts as another option.[24] Most importantly, the USTA II court preserved the Commission's impairment standard, albeit offering some "suggestions" for improvement.

The USTA II court suggested that rolling hot cuts would eliminate this disadvantage. In a large market with significant density, this approach might reduce the costs and delays associated with converting the customer to the new carrier. However, this approach does not address the cost concern for the residential customer, and additionally creates the new problem of putting the customer through multiple conversions which often result in service affecting problems. As customers are affected by these service problems they invariably blame the competitor, to the incumbent's advantage.

## IV. TO ENSURE THE BENEFITS OF COMPETITION TO MASS MARKET CUSTOMERS, THE COMMISSION SHOULD ADOPT A LINE DENSITY THRESHOLD TRANSITION MECHANISM

ACN strongly advocates the continuance of UNE-P as a means to enable ACN to provide a robust, competitive alternative to ILEC residential services, especially to customers outside of metropolitan areas. ILEC's have incorrectly portrayed the harm to their business from using TELRIC pricing models. Moreover, they have overemphasized the contribution of auxiliary services, such as long distance bundling, to CLEC revenues, while simultaneously underemphasizing the contribution that their Section 271 long distance entry has made, and will continue to make, to the BOCs' overall profits, notwithstanding whatever costs are associated with the unbundling that this long distance approval was conditioned on, and which they now seek to eliminate.

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[24] *Id*.

As if the Commission actually needed to be reminded, it has been directed by USTA II to review the mandate of USTA I that "the Commission may not 'loftily abstract[ ] away from all specific markets,' but must instead implement a 'more nuanced concept of impairment.'"[25] In the interest of developing a more "nuanced concept of impairment," these Comments seek to persuade the Commission that, in ACN's experience, there are indeed markets in which requesting carriers are impaired, at least for a certain duration of time, without access to unbundled elements. For that reason, ACN proposes the following:

First, the Commission should establish separate impairment tests for residential versus commercial lines.

Second, the Commission should find that requesting carriers are impaired without access to mass market unbundled switching provided to residential customers in central offices with in which the requesting carrier serves fewer than 3,500 lines. As opposed to transition plans implemented over an arbitrary period of time, a density-based plan best addresses at least three of the key factors that the Commission favors in gauging entry barriers:

- Scale Economies: It goes without saying that line density is the epitome of the type of indicator used to measure economies of scale.
- Sunk Costs: Once the threshold is reached, the new entrant is in a position to generate the cash flow necessary for debt service on large capital investments (particularly the cost of a switches and collocation arrangements), or to attract investment capital for the same purpose. Moreover, with sufficient line density, a

[25] *USTA II* 359 F.3d at 569 (citations omitted).

new entrant is better insulated from the vagaries of customer turnover, making it safer to incur large sunk costs.

- First Mover Advantages: At the suggested threshold, a new entrant is no longer an unknown in the market place, and at that point has the market exposure and depth to counteract more of the first mover advantages of the incumbent.

Moreover, the Commission, while not adopting similar density-based plans, has indicated a familiarity with the concept and did give credence to these plans in its overall reasoning.[26]

It should also be noted that technology advancements will introduce a self-limiting function into CLEC migration plans. As technology makes self-provisioning viable for CLECs serving residential customers in wire centers with decreasing density, the CLECs will wean themselves off of ILEC unbundled switching or risk losing customers to the ILEC or other competitors.

Finally, once a carrier has reached the 3,500 line threshold, it should be given a transition period of 18 months to migrate all of its customers off of the ILEC switching platform.

[26] *Triennial Review Order* para. 530.

## V. CONCLUSION

Accordingly, the Commission should adopt the transitional mechanism described herein.

Respectfully submitted,

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October 4,2004

# Exhibit 1

## “Grandfathering of Products – PA,” Verizon Industry Letter, Oct. 1, 2004

# Re: Grandfathering of Products - PA



October 1, 2004

**Subject: Grandfathering of Products - PA**

Verizon Pennsylvania Inc. has filed requests with the Pennsylvania Pu
Commission (PUC) to grandfather the products/services listed below w
date of November 22, 2004. The grandfathering of these products/ser
CLECs who resell products/services in the state.

Customers who subscribe to any of these products/services may retai
existing address; however, if they either cancel them or move the acc
grandfathered product/service to a new address, they will no longer be
them.

Residence Impacted Products/Services:

- Residential Foreign Central Office
- Selective Exchange Calling
- Metro Call Pak
- Multi-Line Package Bonus
- Verizon Metropolitan Package
- Verizon Metropolitan Package Extra
- SoundDeal
- IntellinQ BRI Service
- Digital (ISDN) Single Line Service
- Select Call Forwarding
- Priority Call
- Call Block
- Home Intercom
- Intercom Extra
- Special Call Acceptance
- VIP Alert

Business Impacted Products/Services:

- Maximum Value Plan
- Business Calling Plus
- Business Optional Calling Plan
- WATS

- Verizon North Easy Savings Plan for Business
- Select Call Forwarding
- Priority Call
- Call Block
- Advantage Pak
- Special Call Acceptance
- VIP Alert

If you have any questions, please contact your Account Manager.

# Exhibit 2

# Yankee Group News Release

YANKEE GROUP

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# Yankee Group News Releases

## The Yankee Group Expects the Consumer Local VoIP Indu Grow More Than 100 Times Its 2003 Size

**NEWS RELEASE - 30 AUG 2004**

***Vonage defined the consumer local access VoIP industry in 2003, leading pos threatened as major players enter the market***

BOSTON - According to the Yankee Group report, *Despite Uncertainty, Leading Te Industry Players Commit to Mass-Market VoIP Deployment*, voice over IP (VoIP) w close to 1 million subscribers by year-end 2004, and serve 17.5 million U.S. househ year-end 2008, growing from 131,000 at year-end 2003.

Although Vonage dominates the market, cable MSOs will take the lead quickly. Cal will capture 56% of the U.S. local VoIP market by year-end 2005, while market sha alternative voice provider category will decrease from 66% in 2003 to 19% in 2005. drive cable telephony efforts and surpass circuit-switched cable telephony in 2006; cable MSOs' share of the local telephony market will reach nearly 10%.

After many years of testing, VoIP is finally ready, and major industry players are co mass-market deployment of their VoIP services. The success of Vonage--and the r regulatory turmoil--has spurred a dramatic response from major telephony players. Verizon and Qwest have committed to local VoIP rollout strategies for 2004, while S and BellSouth view the consumer VoIP market with more caution.

"These companies have the potential to capitalize on the market's momentum," say Griffin, Consumer Technologies & Services senior analyst. "Although alternative pla the MSOs maintain a head start in the consumer VoIP market, U.S. telcos can leve knowledge of telephony delivery, marketing, support and brand recognition. Operat brave the uncertainty and enter the VoIP market will gain the ability to define the se set consumer expectations."

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**The Yankee Group (http://www.yankeegroup.com)**

The Yankee Group is the global leader in communications & networking research a consulting. The company helps businesses understand the opportunities, risks and competitive pressures of developing, deploying and consuming products and servic drive communication or information exchange. Now in its fourth decade, the Yanke based in Boston with offices throughout North America and Europe.

# Exhibit 3

## "For Good Jobs and a Strong Economy"
## SBC – Michigan Pamphlet

# For Good Jobs and a Strong Economy,

## Michigan needs healthy and fair competition in the telecom industry

## So, what's at stake?

The bottom line issue is Michigan's ability to attract and keep good jobs and build our economy for the future. A critical factor in making Michigan a high-tech state is building and maintaining a high-tech communications network and right now, regulations and regulators in Michigan are threatening the state's ability to do just that.

**The information to follow is an effort to help you and your office answer any questions you may receive.**

## A little background

There are several ways for companies to offer local phone service in Michigan.

**Self Provisioned:** Companies that own their own switches and own the facilities that connect those switches to their end user customers.

**UNEs:** The ability of a company that owns some facilities to lease additional elements necessary to provision telephone services. The most common approach is for the company to own its own switch and to lease an unbundled loop from SBC Michigan to reach its end user.

**Resale:** The ability of a company that has not constructed any network facilities of its own to resell retail services on the incumbent telephone company's network. Resold lines get about an 18 percent discount from current retail rates.

**UNE-P:** The unbundled network element platform (UNE-P) provides a competitor to SBC Michigan everything it needs to offer local service to customers. UNE-P provides competitors the same functionality as resale but at a substantial discount (60 percent). Many competitors use this today because of its artificially low price, including those that already have and use their own switches, such as MCI and AT&T.

This wholesale product (UNE-P) is made up of three primary elements:

- **Loop** – The line from the phone company's office to the customer
  - The loop is the most expensive component of the UNE-P to provide and allows non-facilities-based telecommunications providers to deliver service without laying network infrastructure
- **Port** – The line connection to the phone company's switch
- **Shared Transport & Local Switching** – The phone company connection to the rest of the telecommunications network

## How did we get here?

**FCC mandated UNE-P to increase competition.** The federal Telecommunications Act of 1996 mandated that local phone companies like SBC Michigan make their networks available to competitive local exchange carriers (CLECs), allowing them to choose and combine unbundled network elements (UNEs). The prices for network elements must be "based on cost" and "may include a reasonable profit." To achieve this mandate, the FCC developed a pricing formula called Total Element Long Run Incremental Cost" (TELRIC).

The FCC's goal was to increase telecommunications competition across the country and provide a stepping stone for new competitors to get into the business and eventually begin investing in their own facilities and network.

## Did their plan work? Yes...

**Competition is thriving.** Telecommunications competition is thriving. Customers and businesses can choose from competitors such as wireless, wireline, cable telephony, Internet telephony, e-mail and instant messaging to name a few. Michigan is among the leaders in local competition, with competitors serving about 2.2 million access lines in SBC Michigan's service territory (37 percent). That's almost 4 out of every 10 customers.

## ...and No.

This competition is artificial. Instead of investing in their own network, as was the goal of the Telecommunications Act of 1996, competitors have become increasingly dependent on the government-mandated UNE-P crutch. Competitors to SBC Michigan use UNE-P to serve 54 percent of their customers.

**SBC Michigan is subsidizing competitors.** In Michigan, the current wholesale rates are priced well below cost. Phone competitors using SBC Michigan's network pay a monthly average of about $15 per line, but sell the services provided over that line for much more. For example, in Michigan, AT&T sells its OneRate® plan for $48.95, a 228% mark up over what it pays SBC Michigan. It costs SBC Michigan an average of $25 per line per month to provide the lines and for our employees to maintain and service them. Quite simply, SBC Michigan is subsidizing its competitors.

**Below-cost wholesale rates stifle investment and cost good jobs.** Below-cost wholesale prices are bad for the long-term growth of Michigan because they drain away dollars needed to maintain and improve the state's network. Below-cost wholesale prices also encourage competitors to lease our lines and resell our services, rather than invest in telecommunications equipment of their own. Companies leasing SBC Michigan's network via UNE-P do not create Michigan-based jobs, do not invest in Michigan's network, and do not bring technology or innovation to customers.

## How do we fix this problem?

**SBC Michigan is asking the MPSC for a wholesale rate of $25.** This amount is based on cost studies approved by the FCC (TELRIC). State commissions set TELRIC prices based on what it would cost a new local competitor today to build and operate a hypothetical, most-efficient telephone network using existing technology that can provide the same services as the incumbent local phone carrier's existing network. SBC Michigan's proposed cost of $25 reflects the forward-looking economic cost of building a new network.

## But won't that make phone bills go up?

Short answer: NO!

Right now, if you look across America, SBC competitors like AT&T are offering phone customers a so-called OneRate® Plan. At the same time, however, UNE-P rates are different in almost every state.

A quick example: In Minnesota, the UNE-P rate set by the state is about $25. AT&T's OneRate® Plan costs $48.95. In Michigan, our UNE-P rate is just under $15, and still AT&T's OneRate® Plan is $48.95.

Bottom line: Higher UNE-P rates in other states haven't caused phone bills to go up, and one of the America's lowest UNE-P rates here in Michigan hasn't saved people money.

## What's next?

**The MPSC is reviewing SBC Michigan's wholesale rates.** SBC Michigan's wholesale cost case currently at the Michigan Public Service Commission (MPSC) is critically important. Even though the telecommunications industry has undergone dramatic changes in the past five years, Michigan's current wholesale rates, which are well below-cost, have not been reviewed since 1999. Bottom line is that Michigan is trying to compete in a 21st century world under 20th century regulations and red tape.

The MPSC does not have a mandated deadline to rule on this critical issue, however we are hopeful the Commission will look to the future – not the past – of our state's telecommunications industry, put an end to the subsidies in Michigan and protect jobs all at the same time.

## What can you do to help?

Call on the MPSC to do the right thing and not stand in the way of Michigan job providers or job creation. $25 is a small price to pay to protect good jobs.

**Establishing accurate wholesale rates is necessary to protect jobs and ensure healthy and sustainable telecommunications competition in the future – to the benefit of Michigan consumers, businesses and our economy.**

**Opinion Editorial – Legislators (Draft)**

We support SBC Michigan's filing at the Michigan Public Service Commission. Michigan's largest local telephone company is making a reasonable business request for the ability to recover the cost of providing and maintaining the lines that it leases to its competitors. It doesn't make sound business sense to have a company subsidize its competitors.

The current below-cost wholesale rates not only hurts SBC Michigan and its employees, but also Michigan businesses and consumers. Many competitive phone companies in our state are not investing in their own facilities and they are not creating Michigan-based jobs. And, SBC Michigan has fewer dollars to invest in jobs and infrastructure.

Our economy is suffering because of these low wholesale rates and that makes our state less desirable for new businesses and residents to grow and relocate. Consumers also are not getting the benefits of an advanced network, improved efficiency and opportunities for new and innovative technology applications that comes from true competition.

Michigan's wholesale rates should be right around $25. Even one of the largest competitors to SBC Communications agrees, as evidenced by Sage Telecom's 7-year deal with SBC to replace the regulatory-mandated wholesale rates. Negotiations like this are an example that telephone companies can come together and accomplish fair, market-based agreements.

The Commission needs to establish accurate wholesale pricing now, which truly reflects SBC Michigan's costs. Making a positive ruling on this issue will spur investment and job growth back into Michigan's telecommunications industry and our economy. Michigan's consumers, businesses and economy deserve to have a solid telecommunications industry they can depend upon.

As legislators we are committed to growing jobs and increasing investments in Michigan. SBC Michigan's ability to recover the cost of providing the lines it leases to competitors is necessary for Michigan's continued growth and success.

# # #

**Contacting the Michigan Public Service Commission**

The Honorable J. Peter Lark
The Honorable Laura A. Chappelle
The Honorable Robert B. Nelson
Michigan Public Service Commission
6545 Mercantile Way, Suite 7
Lansing, MI 48911

**Fair and healthy telecom competition is necessary**

- I support SBC Michigan's filing (Case No. U-13531) at the Michigan Public Service Commission.
- SBC Michigan is making a reasonable business request to charge what it actually costs to provide and maintain the lines that it leases to its competitors.
- Establishing a $25 wholesale rate will ensure that Michigan residents and businesses have healthy and sustainable telecommunications competition in the future and help retain and grow Michigan jobs and investment.

**Below-cost wholesale prices are harmful for Michigan**

- Below-cost wholesale prices are detrimental to the long-term health of Michigan's telecommunications network.
    - If SBC Michigan can not recover its costs, it will hinder its ability to invest in infrastructure, new technology and innovation.
    - If competitors continue to lease from SBC Michigan at deep discounts, they will have little or no incentive to invest in infrastructure and new technology.
    - Jobs in Michigan are at risk
- Consumers and businesses ultimately lose with below-cost wholesale pricing.

**The MPSC needs to act now**

- I respectfully urge the Commission to issue a timely order establishing a wholesale rate, which truly reflects SBC Michigan's costs.
- A wholesale rate of $25 reflects industry standards and will promote more investment in infrastructure, protect jobs, preserve competition, and allow SBC Michigan fair reimbursement.
- Thank you for your help in ensuring Michigan's telecommunications industry continues to grow and benefit consumers and businesses.

# # #

# Supporters of SBC Michigan's Cost Case

**Chambers of Commerce**

- Saginaw County Chamber of Commerce
- Grand Rapids Area Chamber of Commerce
- Macomb Chamber of Commerce
- Greater Port Huron Chamber of Commerce
- Flint Area Chamber of Commerce
- Sterling Heights –Utica – Shelby Township – Chamber of Commerce
- Ypsilanti Chamber of Commerce
- Kalamazoo Regional Chamber of Commerce
- Monroe County Chamber of Commerce
- American Arab Chamber of Commerce
- Plymouth Community Chamber of Commerce

**Economic Development & Business Organizations**

- Middle Michigan Development Corporation
- Saginaw Future Inc.
- Detroit Entrepreneurship Institute, Inc.
- Economic Development Alliance of St. Clair County
- Flint-Genesee Economic Growth Alliance
- Monroe County Industrial Development Corporation
- Economic Development Council of Livingston County
- Booker T. Washington Business Association
- Mount Clemens Downtown Development Authority
- Delta County Economic Development Alliance
- Economic Development Council of Livingston County
- Operation Action UP
- Jefferson East Business Association

**City and County Officials**

- B. Mark Neal, Port Huron Mayor
- Marty Griffin, Jackson Mayor
- Titus McClary, Highland Park Mayor
- Dorothy Edwards, Monroe City Council Member/Mayor Pro-Tem
- Robert L. Judd, Mayor Pro-Tem, City of St. Joseph
- Mike Severino, Ingham County Commissioner
- Chris Swope, Ingham County Commissioner
- Ted Hammon, Genesee County Commissioner
- Vincent Gregory, Oakland County Commissioner
- Jeff Mays, Supervisor, Charter Township of Bangor
- Ann Brown, City Councilwoman, Dearborn Heights

**Community, Civic & State Organizations**

- Nathan Weidner Children's Advocacy Center
- Saginaw County Boys and Girls Club
- Sphinx Organization
- Nonprofit Enterprise at Work (NEW)
- Closing the Digital Gap
- The Senior Alliance
- Boys & Girls Club of Lansing
- YouthFriends Michigan
- The National Conference for Community and Justice
- Macomb County Rotating Emergency Shelter Team (MCREST)
- American-Arab Anti-Discrimination Committee
- Volunteers in Prevention Probabtion & Prisons Inc.
- Michigan Citizen Action
- Think Detroit
- Female Athletic Association Boosters of Wyandotte
- Stepping Stones Therapeutic Riding, Inc.
- Lily Missions Center

**Michigan State Legislators**

- Speaker Rick Johnson, R-LeRoy
- Sen. Jim Barcia, R-Bay City
- Sen. Mike Goschka, R-Brant
- Sen. Michelle McManus, R- Lake Leelanau
- Rep. Clark Bisbee, R-Jackson
- Rep. Barbara Farrah, D-Southgate
- Rep. Kathleen Law, D- Gibraltar
- Rep. Jennifer Elkins, D-Lake

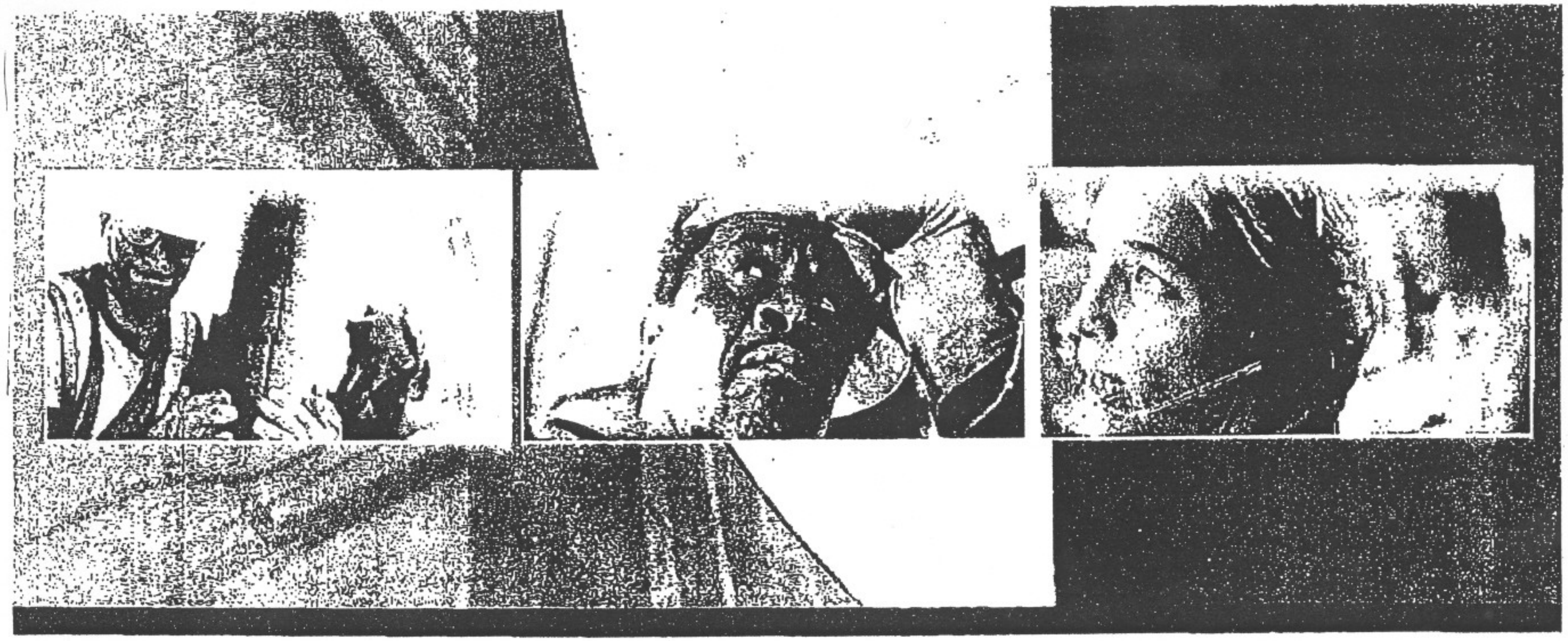
**Education, Health & Media**

- Upper Peninsula Health Plan
- Marquette General Health System
- Bill Liebold, President, Michigan Colleges Foundation
- Donald Torline, President, Baker College of Clinton Township
- Payne-Pulliam School of Trade and Commerce
- Citadel Broadcasting Corporation

**Community Leaders & Members**

- Jesse W. Bell, President, Bell Financial Services
- Ric Wiltse
- John Colina, Colina Foundation
- Homita McDonald
- Mary Jo Fifarek, SBC Michigan Retiree
- David Gensor, SBC Michigan Retiree
- Trudy Nowicki, SBC Michigan Retiree

- Michael Nowicki, SBC Michigan Retiree
- Bridget F. Chaney, SBC Michigan Retiree
- Barb Prior, Midland Community Member
- Edward & Mary Lobsinger, Beaverton Community Members

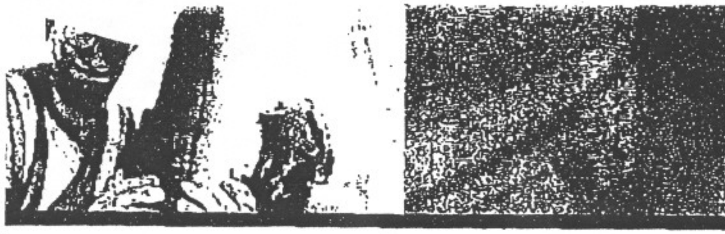


# Michigan's Economy Needs Healthy and Fair Telecom Competition

SBC

# Who We Are – SBC Michigan

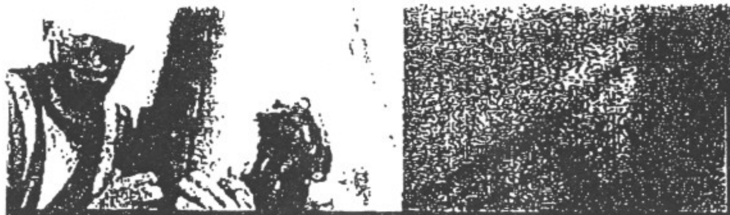
| | |
|---|---|
| Annual Payroll | $725 million |
| Network Investment | $407 million |
| Taxed Paid | $305 million |
| Goods and Services | $246 million |
| Grants Awarded | $4 million |
| Volunteer Hours | $1 million |
| | |
| Total | $1.6 billion |



## SBC's Financial Picture

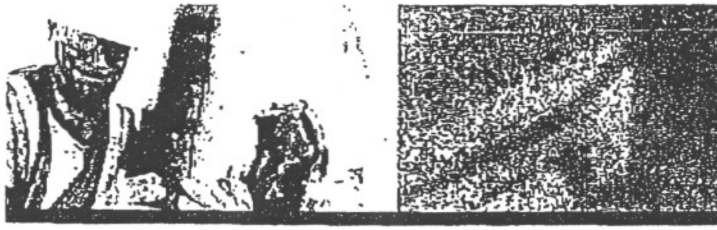
# We're facing big challenges.

- **Earnings** in 2003 were **down 20 percent** from 2002.
- **Revenues** in 2003 **fell $2.3 billion.**
- **Consumer Retail Access Lines**, the core of our business, have **fallen by 10 million lines** since 1999 (18 percent).
- **UNE-P lines** have risen five-fold since 2000, to **6.6 million.**



# SBC's Financial Picture

- **Why?**
  - **Economy**
    - Telecom industry hit hardest
  - **Competition**
    - Michigan leads in local competition; competitors serve about 2.2 million lines (37 percent) in SBC's service territory
  - **Imbalanced regulatory environment**
    - Current laws impede growth



# A parallel track of disinvestment

## SBC Michigan

Selling our wholesale service at below-cost prices means fewer dollars available to invest in the network

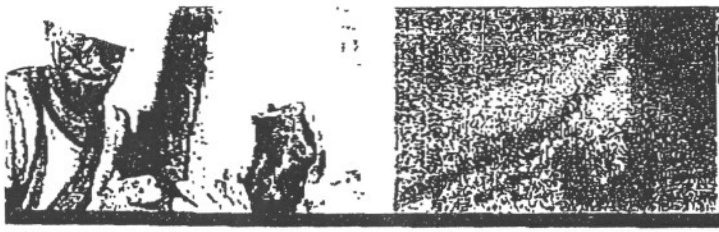
If SBC can't recoup its costs, it cannot make continued network investments

## CLECs

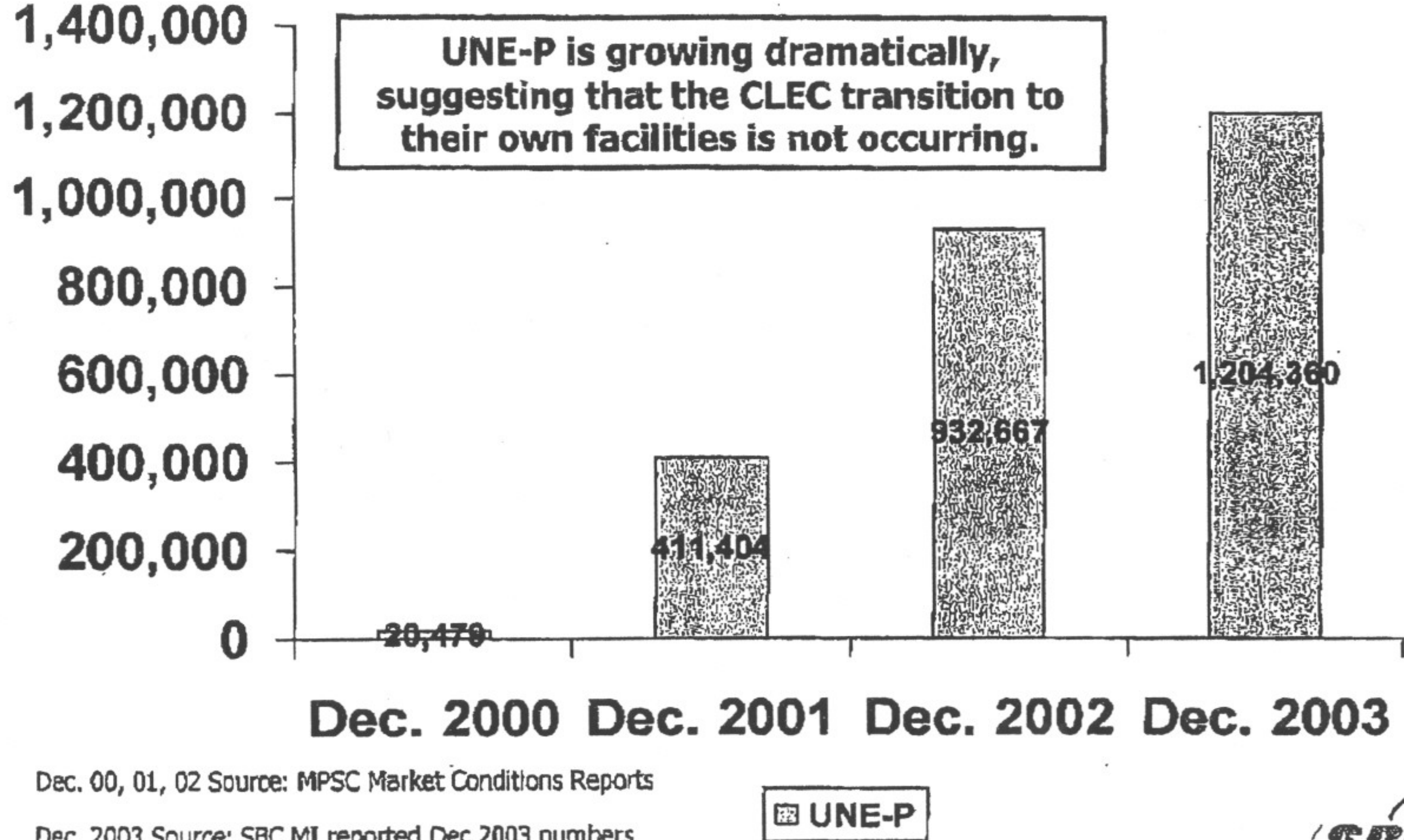
Below-cost wholesale prices encourage competitors to lease our network

Competitors leasing our network do NOT invest in Michigan's network

**Michigan's Telecommunications Network Suffers**



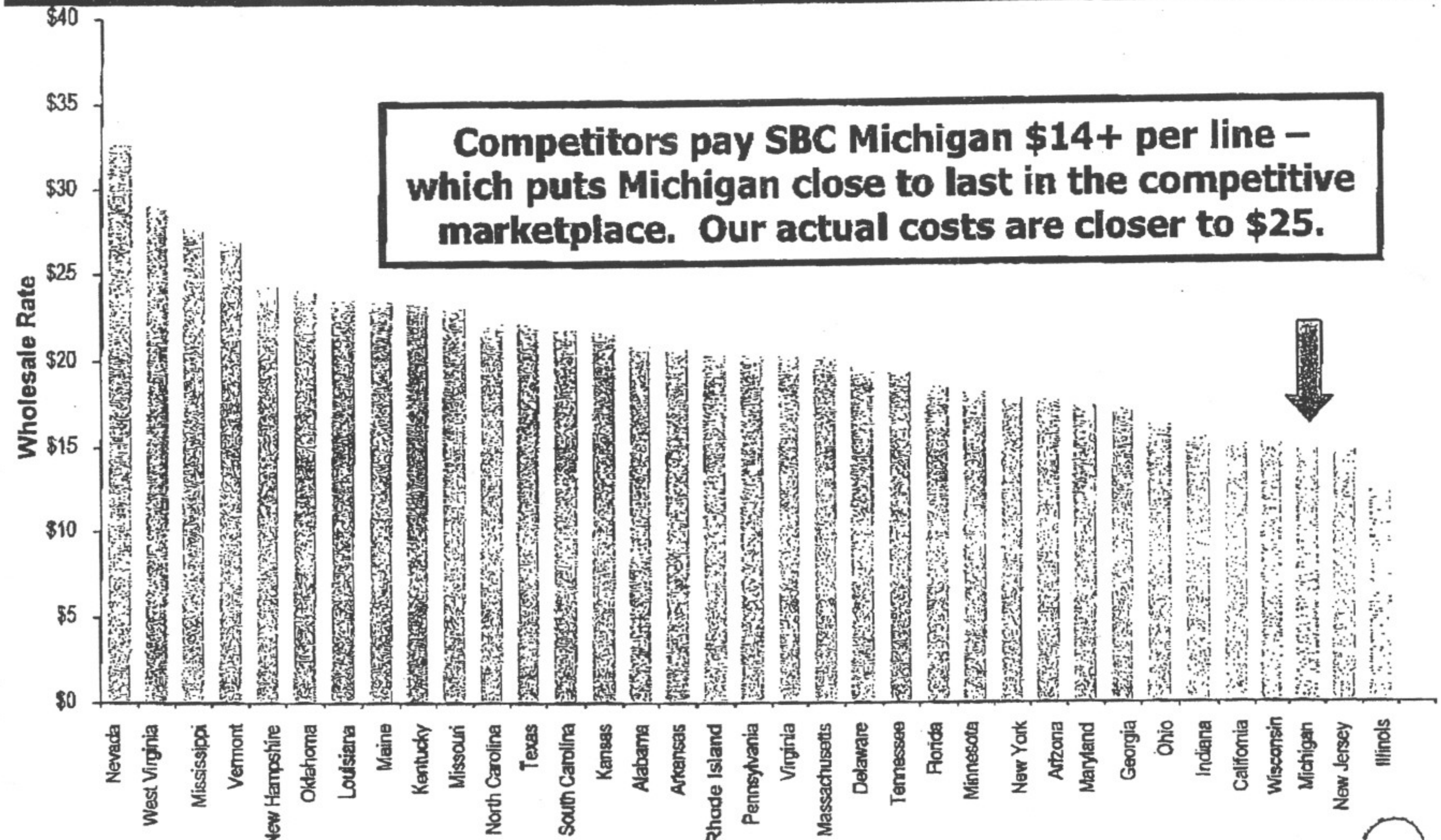
# Competitors are Using SBC Michigan Service Instead of Investing




Dec. 00, 01, 02 Source: MPSC Market Conditions Reports

Dec. 2003 Source: SBC MI reported Dec 2003 numbers to the MPSC in Feb. 2004 (2003 MPSC number not released yet)

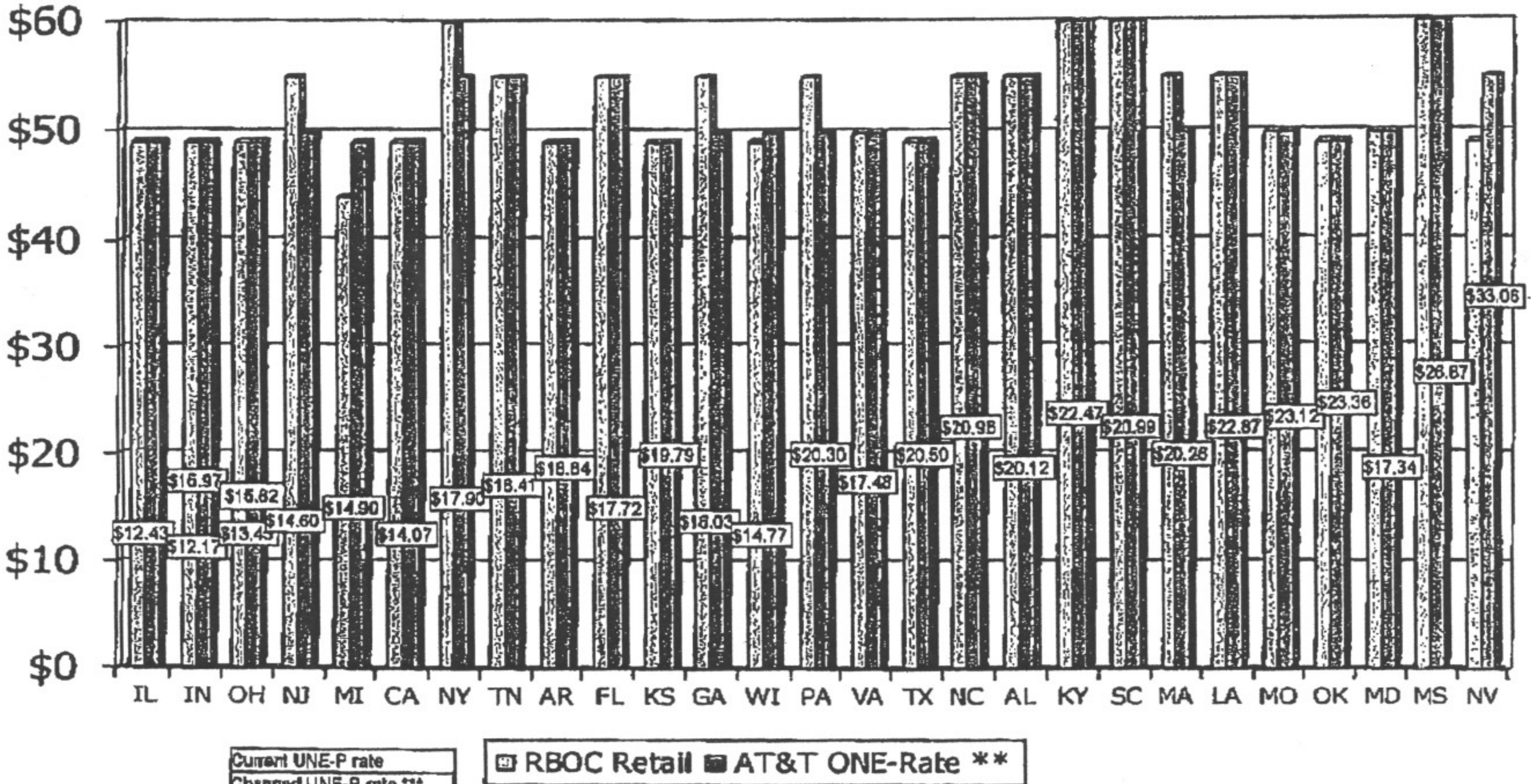
# Few States Have a Lower Wholesale Rate Than Michigan




UNE-P pricing derived from LECG Inc. and Northwestern University, Dr. Debra Aron, January 2004.

SBC

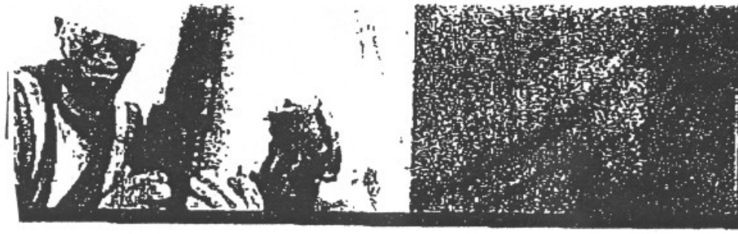
# Lower UNE-P* Rates Don't Equal Lower Consumer Prices




*The source for these figures is LECG Inc. and Northwestern University, Dr. Debra Aron, February 2004.

**Monthly charge includes unlimited local calls, interLATA long distance, and intraLATA toll. AT&T One Rate USA includes four calling features and MCI Neighborhood Complete includes five calling features. Excludes Subscriber Line Charge and other miscellaneous taxes and fees. Prices may vary by city or zone within a state.

***The rates have been updated to reflect State Commissions' rate changes. Indiana's rate change was effective January 5, 2004. In Ohio, an interim UNE rate increase is pending. On April 2, 2004, the New Jersey Board of Public Utilities approved a 14.3% increase in UNE-P rates (new rate not reflected).



# Our competitors' strategy

## No Capital Investment

"We're profitable everywhere we sell because we limit ... where we sell based on cost.... **[W]e're deploying very little capital to make it work."**

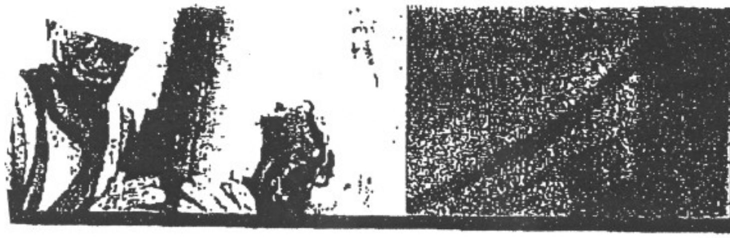
*Wayne Huyard, COO, MCI WorldCom*

## High Margins, Low Risk

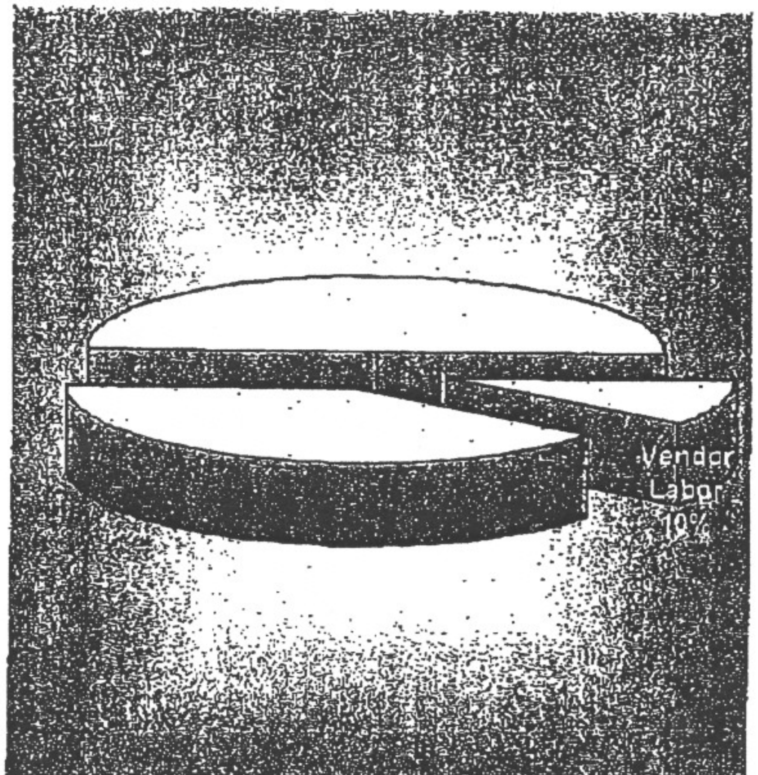
"Our principle of maximizing cash requires that **we only enter states that meet our gross margin requirements."**

"We are not going into states where we don't have a gross margin of **45% on the local** ..."

*Betsy Bernard,*
*Former President*
*AT&T Consumer*

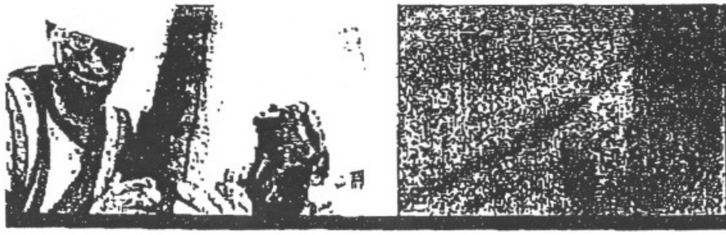


# Impact of Investment on Jobs




Labor as a percent of investment

- 60 percent of SBC's network investment directly supports jobs
- SBC has reduced workforce by almost 10 percent in the last year
- Continued reductions in capital spending will likely impact existing jobs

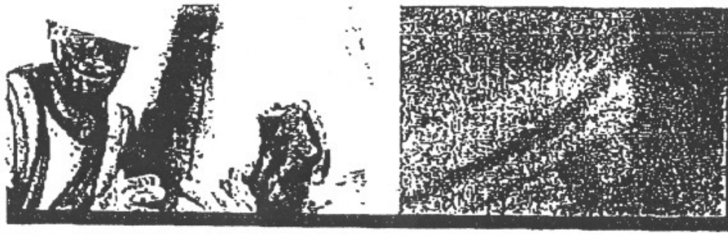


## What is the Right Direction for Michigan?

- Regulations & laws need to focus on strengthening Michigan's telecom industry to grow our economy.

- Establishing a $25 wholesale rate which allows SBC Michigan to recover its cost will:
  - Maintain and enhance Michigan's telecommunications network
  - Ensure consumers have viable and sustainable telecommunications choices
  - Help retain Michigan-based jobs
  - Ensure the state's future competitiveness

- Growing, profitable companies with good-paying, secure jobs benefit Michigan and its consumers.



# What has to happen?

- The Michigan Public Service Commission, the Governor and the Legislature need to recognize that **the status quo in Michigan is hurting our economy and putting jobs at risk.**
- As a true partner in Michigan's future, **SBC Michigan must be allowed to recover its cost of doing business.**
- The MPSC needs to embrace technology and innovation and resist the bureaucratic urge to tie the hands of job providers with unfair regulation and 20th century pricing schemes.
- The MPSC must increase wholesale rates to $25 – the true cost of doing business in Michigan – in order to increase investment, spur economic growth and save good jobs.
- **It's not only the economically responsible thing to do, it's the right thing to do for Michigan.**

THE DAILY OAKLAND PRESS

EDWARD R. MOSS
President & Publisher
745-4501

EDITORIAL

# Lower-cost phone services are getting rich off SBC

SBC Communications — otherwise known as the phone company — says it has a problem.

Given its history, and being born as the monopoly Michigan Bell, the claim tends to be received skeptically.

That's especially so in the case of state residents and businesses happily taking advantage of the phone service provided by one of SBC's many new competitors, such as TalkAmerica.

They typically offer precisely the same service options as SBC, but for at least $10 a month less. The assumption is that it's one of the fruits of deregulation, the end of monopolies in many industries and services.

But that's not really true.

What's going on is a sort of accidental product of the U.S. Federal Communications Commission, which still makes the rules. It was well-intended when it acted to encourage local phone competitors, but the result is nonsensical.

About 90 percent of whichever new phone service you're buying actually is provided by SBC. It is purchased by the new company and resold to you at a rate lower than SBC itself can charge, according to Michigan Public Service Commission rules.

The FCC imagined that the fledgling competitors, having established a toehold in the market, would begin to invest in their own phone networks.

But why on earth would they?

SBC isn't investing much, either. Again, why would it? Most of the benefits would be skimmed off by competitors, by law.

In fact, SBC is obligated to build and install new phone facilities sought by customers, even though SBC knows they'll buy a competitor's service with that equipment.

This is compelling adults to do crazy things, with some laughing all the way to the bank and the rest seeing their enterprises being drained of income.

Stockholders in the new "competitors" are giddy while those of SBC are selling out at ever lower prices.

If this were the result of heads-up competition across the board, it would be one thing, but it isn't.

To top it all off, this bizarre host-parasite relationship effectively ignores the obvious presence of a huge amount of new phone competition from cell and Internet providers.

SBC and companies like it have plenty of marketplace pressure that was undreamed of in the Michigan Bell and even Ameritech eras.

At the same time, the presence of its local competitors has not prompted either party to reduce rates further or improve services, the supposed justification for what's going on.

That's because it is less classic competition than what has been called the legal taking of private property, SBC's physical facilities.

The new companies should be forcibly weaned from the SBC network, which would encourage them to invest in equipment of their own. That still might allow them to sell phone service for less because of new and more efficient facilities.

There is no rational reason, especially in the new context of cell and Internet providers, that any established phone company should be forced to indefinitely subsidize a competitor.

As much as we all like to save money, this isn't fair.

THE DAILY OAKLAND PRESS

## GOOD MORNING

Why does at least one of the Big Three always have to be in the midst of a "turnaround"?

# Exhibit 4

## "Restoring the Promise of Local Competition"
## CompTel/ASCENT Whitepaper

# Restoring the Promise of Local Competition:

## *Avoiding Crisis by Establishing Just and Reasonable Terms, Conditions and Prices Under Section 271's Social Contract*

It will be several months before the Supreme Court decides whether to review the *USTA II* decision by the DC Circuit Court of Appeals,[1] and longer still before it can restore the federal Telecommunications Act to its intended purpose "to give aspiring competitors every incentive to enter local retail telephone markets, short of confiscating the incumbents' property."[2] Fortunately, in territories served by the affiliates of the Regional Bell Operating Companies (RBOCs), state commissions can take immediate steps to ensure that the competitive gains made possible by the Act are preserved by establishing the just, reasonable and nondiscriminatory terms for those network elements that must be offered for an RBOC to comply with section 271 of the Act.

There is no question that the RBOCs have voluntarily agreed to open their networks by accepting the terms of the social contract outlined in Section 271 of the Act. There are, however, open questions that must be resolved to translate the obligations of section 271 into concrete offerings that will avert the competitive crisis caused by the *USTA II* mandate. By taking this step now, state commissions will determine the baseline offerings that will be available no matter *when* and *how* the issues involving the ongoing litigation concerning section 251 are ultimately resolved.[3]

The purpose of this white paper is to explain how state commissions, exercising their clear responsibility to

**Key Points**

- Section 271 provides an independent obligation to unbundle that the RBOCs voluntarily accepted for long distance authority.
- Section 271 requires the RBOC to offer checklist UNEs through interconnection agreements approved pursuant to section 252 of the Act.
- Congress explicitly charged state commissions with the responsibility to arbitrate section 252 disputes, a duty that includes arbitrating the terms, conditions and prices of section 271 elements.

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1 *United States Telecom Association v. FCC*, No. 00-1012 (D.C. Cir. March 2, 2004) ("*USTA II*").

2 *Verizon Communications v. FCC*, 535 U.S., (May 13, 2002) ("*Verizon*").

3 The decision by the Bush Administration to not support Supreme Court review of *USTA II* will do nothing to reduce uncertainty, curtail litigation, or avert crisis in competitive markets. The RBOCs are already threatening litigation even before the FCC has the opportunity to develop new unbundling rules under section 251 (*see* letter of Michael Kellogg on behalf of USTA to FCC General Counsel John Rogovin, June 24, 2004); there is no reason to expect the RBOCs will not further litigate those issues not reached by *USTA II* (including the impairment definition adopted by the TRO); and the RBOCs have made clear their intention to dramatically increase wholesale costs (and thus the retail rates paid by consumers) immediately after the election.

arbitrate access and interconnection disputes arising from section 271, can prevent the competitive crisis created by the DC Circuit. As we explain below:

* Each of the key network elements required by CLECs to compete are specifically enumerated in section 271, forming an independent obligation unrelated to the necessary and impair issues in section 251.

* Section 271 offerings must be implemented through interconnection agreements approved according to section 252.

* Section 252 provides that state commissions are responsible for arbitrating disputes, including those disputes concerning the offering of elements required under section 271.[4]

* There is an immediate need for state commissions to address ongoing prices for those network elements affected by *USTA II*, as well as to define the RBOCs' obligation to provide nondiscriminatory access to UNE arrangements that include both section 271 and section 251 UNEs.

The RBOCs voluntarily accepted section 271's obligations in return for the right to provide in-region long distance service. As everyone knew when the Act passed, the RBOCs' ability to bundle local and long distance would be the most powerful force in post-divestiture telecommunications. Today the RBOCs provide long distance service to more than 43 million lines (in contrast to the 16 million UNE-P lines earned by competitors, and 4 million lines served through unbundled loops). On average, during the first quarter of 2004, the RBOCs gained more than <u>eight</u> long distance lines for every local line they lost to a competitor using unbundled network elements,[5] and are rapidly coming to dominate the market for bundled services and, as a result, the interexchange market as well.[6]

Until now, it was unnecessary to define with precision the exact terms, conditions and prices applicable to items required by section 271's competitive checklist because such obligations largely duplicated parallel obligations incorporated in the regulations implementing section 251. It is now time, however, for state commissions to make sure that these 271 obligations credibly enable bundled-services competition by translating the obligations of section 271 into clear requirements that can easily be incorporated into interconnection agreements by the RBOCs and their CLEC competitors. In the absence of arbitrated decisions, the RBOCs have indicated they will unilaterally impose anticompetitive wholesale rate increases, and competitive carriers will be forced to abandon additional markets. The competitive vision embraced by Congress when it passed the Telecommunications Act will be lost.

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[4] Although the FCC has the authority to enforce section 271 through actions that include, for instance, the withdrawal of an RBOC's interLATA authority, that enforcement authority does not diminish, in any way, the state's obligation to arbitrate interconnection agreements required by section 271, including the establishment of rates for items required by the competitive checklist.

[5] Data as of 1Q2004 (Source: RBOC Quarterly Earnings Statements).

[6] In the first state RBOC long distance entry was allowed (New York) the RBOC has already achieved 61% long distance market share, just shy of the share AT&T had when it was still considered a dominant, and fully-regulated, long distance carrier. The only counterbalance to the RBOCs achieving complete dominance offering bundled services is the local competition made possible by access to network elements.

**Section 271 Requires Ongoing Access to Loops, Switching, Transport and Signaling at Rates and Terms that are Just, Reasonable and Nondiscriminatory**

Congress well understood that undoing the AT&T Divestiture Agreement and permitting the RBOCs to offer in-region long distance services carried great risk. Consequently, in crafting the additional voluntary obligations that an RBOC must accept in order to offer in-region service, Congress made sure that each of the core elements of the local network – loops, transport, switching and signaling – would be available to competitive entrants in any state where the RBOC was permitted to offer long distance service, without the need for any additional findings by the FCC. As the FCC recognized:

> These additional requirements [the unbundling obligations in the competitive checklist] reflect Congress' concern, repeatedly recognized by the Commission and courts, with balancing the BOCs' entry into the long distance market with increased presence of competitors in the local market…. The protection of the interexchange market is reflected in the fact that section 271 primarily places in each BOC's hands the ability to determine if and when it will enter the long distance market. If the BOC is unwilling to open its local telecommunications markets to competition or apply for relief, the interexchange market remains protected because the BOC will not receive section 271 authorization.[7]

The voluntary social contract contained in section 271 is both simple and powerful: In exchange for opening its *entire* network to competitors, the RBOC is permitted to provide long distance services to its local customers (and others).[8] Most relevant to our purposes here are the following elements of the competitive checklist:

> (B) COMPETITIVE CHECKLIST - Access or interconnection provided or generally offered by a Bell operating company to other telecommunications carriers meets the requirements of this subparagraph if such access and interconnection includes each of the following: . . .
>
> (iv) Local loop transmission from the central office to the customer's premises, unbundled from local switching or other services.
>
> (v) Local transport from the trunk side of a wireline local exchange carrier switch unbundled from switching or other services.
>
> (vi) Local switching unbundled from transport, local loop transmission, or other services.

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7 *In the Matter of Review of Section 251 Unbundling Obligations of Incumbent Local Exchange* Carriers, CC Docket No. 01-338, *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, CC Docket No. 96-98, *Deployment of Wireline Services Offering Advanced Telecommunications* Capability, CC Docket No. 98-147, "Report and Order and Order on Remand and Further Notice of Proposed Rulemaking," FCC 03-36, released August 21, 2003 ("TRO"), ¶ 655.

8 As a practical matter, the RBOCs have generally chosen to focus their long distance offerings on their own local customers and have not engaged in out-of-region entry to any meaningful degree.

(x) Nondiscriminatory access to databases and associated signaling necessary for call routing and completion.[9]

Congress fully understood that local competition would require broad access to the incumbent network, particularly where permitting the RBOCs to offer long distance services could lead to the reemergence of vertical monopolies that the nation had worked so hard to dismantle.[10]

## Section 271 Disputes are Subject to State Arbitration Under Section 252

While there is consensus that the RBOCs must offer each of the elements listed in section 271, there is less agreement as to what that actually means and, equally important, exactly who and how disputes are resolved. The Act, however, is not uncertain – each section 271 network element must be offered through interconnection agreements that are subject to the section 252 review process.

To begin, section 271(c)(2)(A) clearly links a RBOC's obligations under the competitive checklist to its providing that access through an interconnection agreement (or SGAT):

> (A) AGREEMENT REQUIRED - A Bell operating company meets the requirements of this paragraph if, within the State for which the authorization is sought--
>
> `
>
> (i)(I) such company is providing access and interconnection pursuant to one or more agreements described in paragraph (1)(A) [Interconnection Agreement], or
>
> (II) such company is generally offering access and interconnection pursuant to a statement described in paragraph (1)(B) [an SGAT], and
>
> (ii) such access and interconnection meets the requirements of subparagraph (B) of this paragraph [the competitive checklist].

As the above makes clear, the specific interconnection obligations of section 271's competitive checklist (item ii above) must be provided pursuant to the "agreements" described in section 271(c)(1)(A) or the SGATs described in section 271(c)(1)(B). By directly referencing section 271(c)(1)(A) and (B), the Act explicitly ties compliance with the competitive checklist to the review process described in section 252. As section 271(c)(1) states:

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9 Section 271(c)(2)(B).

10 As the Supreme Court recognized in *Verizon*, Senator Breaux, a "leading backer of the Act in the Senate," told the BOCs: "'Now, this legislation says you will not control much of anything. You will have to allow for nondiscriminatory access on an unbundled basis to the network functions and service of the Bell operating companies that is at least equal in type, quality, and price to the access [a] Bell operating company affords to itself.'" *Verizon* at 488 (*quoting* 141 Cong. Rec. 15572 (1995)). Senator Breaux then read the items from the section 271 checklist that specifically require BOCs providing long-distance service to lease the platform of network elements to new entrants.

(1) AGREEMENT OR STATEMENT- A Bell operating company meets the requirements of this paragraph if it meets the requirements of subparagraph (A) or subparagraph (B) of this paragraph for each State for which the authorization is sought.

(A) PRESENCE OF A FACILITIES-BASED COMPETITOR- A Bell operating company meets the requirements of this subparagraph if it has entered into one or more binding agreements that have been approved under section 252 specifying the terms and conditions under which the Bell operating company is providing access and interconnection to its network facilities for the network facilities of one or more unaffiliated competing providers of telephone exchange service (as defined in section 3(47)(A), but excluding exchange access) to residential and business subscribers.[11]

The Act could not be clearer that section 271 network elements must be offered pursuant to the same review process as other (i.e. section 251) network elements.[12] One of the central goals of the Act is to prevent discrimination, and the principal mechanisms to detect and prevent discrimination are the state-review and opt-in provisions of section 252.

The FCC has already addressed RBOC attempts to evade the disclosure, review and opt-in protections of section 252. Specifically, Qwest attempted to end-run section 252 by requesting from the FCC a declaratory ruling that (among other findings) section 271 network elements were not required to be provided in filed interconnection agreements.[13] The FCC rejected Qwest's request, determining section 252 creates a broad obligation to file agreements, subject to specific narrow exceptions that do not exempt section 271 elements. In the *Qwest Declaratory Ruling*, the FCC made clear that any agreement addressing *ongoing* obligations pertaining to unbundled network elements – and the access and unbundling obligations of section 271 fall squarely within that definition – must be filed in interconnection agreements subject to 252 and, to the extent any question remains regarding those obligations, that the state commissions are to decide the issue.[14]

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11 Section 271(c)(1)(A), emphasis added. Because a BOC could only comply with the requirements of section 271 through a statement of generally available terms and conditions (SGAT) if it had not received a request for access or interconnection with 10 months of the Act's passage, the remaining discussion focuses solely on the interconnection agreements described in section 271(c)(1)(A).

12 Although the section is written with reference to a BOC's initial application for in-region, interLATA authority, these are continuing obligations that must be satisfied in order for the BOC to remain in compliance with section 271 and continue to enjoy the opportunity to offer long distance services.

13 Qwest Communications International Inc. Petition for Declaratory Ruling on the Scope of the Duty to File and Obtain Prior Approval of Negotiated Contractual Arrangements under Section 252(a)(1), WC Docket No. 02-89, Memorandum Opinion and Order, 17 FCC Rcd 19337 (2002) ("*Qwest Declaratory Ruling*").

14 For a full discussion of the *Qwest Declaratory Ruling* and subsequent *Notice of Apparent Liability for Forfeiture*, see "The Continuing Path to Local Competition: The Importance of Section 252 to Achieving Just and Reasonable Terms, Conditions and Prices for UNE-P," PACE White Paper, April 2004, available at: www.pacecoalition.org.

**Section 271 Elements Must Be Offered on Just, Reasonable, and Nondiscriminatory <u>Terms and Provide Entrants Meaningful Access to Compete</u>.**

The FCC determined in the TRO that the additional obligations of the competitive checklist must comply with a *potentially* more liberal pricing standard than the standard that applies to elements offered under section 251 of the Act (a conclusion upheld in *USTA II*).[15] Specifically, network elements offered solely in order to comply with section 271 must be just, reasonable, nondiscriminatory and provide meaningful access:

> Thus, the pricing of checklist network elements that do not satisfy the unbundling standards in section 251(d)(2) are reviewed utilizing the basic just, reasonable, and nondiscriminatory rate standard of sections 201 and 202 that is fundamental to common carrier regulation that has historically been applied under most federal and state statutes, including (for interstate services) the Communications Act. Application of the just and reasonable and nondiscriminatory pricing standard of sections 201 and 202 advances Congress's intent that Bell companies provide meaningful access to network elements.[16]

As a threshold point, we observe that there has been some confusion created by the passage above. It is important to understand that the FCC did *not* conclude in the above paragraph that section 271 network elements were directly subject to sections 201 and 202 of the Act (which applies, as the FCC notes, to *interstate* services).[17] Rather, the FCC adopted the just and reasonable rate <u>standard</u> that "has historically been applied under most federal and state statutes," and noted that sections 201 and 202 are an embodiment of that traditional standard. The paragraph is not a statement of jurisdiction – i.e., the paragraph does not say that section 271 network elements are *interstate* services subject to 201 and 202. Rather, the passage describes the appropriate standard of review.[18]

Just as the FCC adopted the TELRIC pricing standard to apply to section 251 UNEs, the FCC has here adopted a potentially more liberal "just and reasonable" standard to be applied to section 271 network elements, and notes that the section 271 pricing standard is the same as is commonly found in a variety of pre-Act statutes (including sections 201 and 202). Adopting a different pricing *standard*, however, does not change the *process* used to resolve pricing disputes, nor does it modify the division of pricing responsibility contained in the federal Act (which

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15 As we discuss in more detail below, the fact that the FCC has adopted a pricing standard applicable to section 271 UNEs that is potentially more lax than its TELRIC rules does not necessarily mean that existing prices should be changed significantly, if at all. TELRIC-based UNE rates are just and reasonable in themselves and it is a fact-based economic question as to whether price levels different than the existing just and reasonable rates are appropriate.

16 TRO, ¶ 663, footnotes omitted.

17 As a practical matter, network elements are predominately used to provide intrastate services (intrastate usage is commonly more than 90%) and, as a result, sections 201 and 202 would almost never govern rates if the traditional separation of regulatory jurisdiction applied.

18 Moreover, when the FCC concluded that the pricing standard of section 252(d)(1) did not apply to section 271, that conclusion did not excuse the applicability of the remaining provisions in 252. Significantly, section 271 was ambiguous as to whether the pricing standard of 252 applied to the specifically enumerated network elements (i.e., loops, switching, transport and signaling), and the FCC resolved that ambiguity by determining that it did not. No such ambiguity exists with respect to the obligation to offer each checklist item through agreements approved according through section 252.

provides that the FCC may define, through rulemaking, a general methodology – in this instance, by adopting the just and reasonable standard -- while it is the states' responsibility to actually establish the rate).[19] Importantly, the adjudicatory process required by section 271 of the Act is no different than the process required by section 251 of the Act – through the arbitration and approval of interconnection agreements in accordance with section 252.[20]

## The Immediate Need for State Action: Establishing the Terms, Conditions and Pricing of Section 271 UNEs

As we have explained above, the RBOCs are obligated, in order to comply with the voluntarily accepted obligations of section 271, to offer specifically enumerated UNEs through state-approved interconnection agreements at just, reasonable and nondiscriminatory terms, conditions and prices. By states resolving critical open issues in this area, state commissions can restore a certain "baseline" to the competitive local market. Two pressing issues are (1) establishing the prices for section 271 network elements and (2) defining *precisely* the RBOCs' obligations to provide existing loop/switching/transport combinations, as well establishing new connections for customers.

As to pricing, it is important to understand two facts; the first is legal, the second economic. First, although the FCC has directed states to apply a "just and reasonable" standard to resolve pricing disputes involving section 271 network elements, the TELRIC-based rates that the states have already established must (by law) satisfy the just and reasonable criteria. In other words, as the states begin the task of defining the basic parameters of just and reasonable rates – and then deciding the specific rate to be applied – the "range" of just and reasonable rates must include the existing TELRIC-based rates.[21] Although section 252(d)(1) does not *automatically*

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[19] The United States Supreme Court affirmed this division of responsibility in *AT&T Corp. v. Iowa Utilities Bd.*, 525 U.S. 366, at 384 (1999), emphasis added:

> " ...252(c)(2) entrusts the task of <u>establishing rates</u> to the state commissions …. The FCC's prescription, through rulemaking, of a requisite pricing methodology no more prevents the States from establishing rates than do the statutory 'Pricing standards' set forth in 252(d). <u>It is the States that will apply those standards and implement that methodology, determining the concrete result in particular circumstances.</u>"

[20] Indeed, we are aware that a number of states (for instance, Tennessee and Georgia) are already addressing the pricing of unbundled local switching being offered under section 271 in arbitrations.

[21] The Act itself requires that rates for section 251 network elements (which the FCC has interpreted to require compliance with the TELRIC standard) must be "just and reasonable." Specifically, section 252(d) PRICING STANDARDS requires:

> (1) INTERCONNECTION AND NETWORK ELEMENT CHARGES-
>
> Determinations by a State commission of the just and reasonable rate for the interconnection of facilities and equipment for purposes of subsection (c)(2) of section 251, and <u>the just and reasonable rate for network elements</u> for purposes of subsection (c)(3) of such section--
>
> (A) shall be--
>
> (i) based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element (whichever is applicable), and
>
> (ii) nondiscriminatory, and
>
> (B) may include a reasonable profit.

apply to section 271 network elements, the existing UNE rates should still inform state commissions as to what should be considered just and reasonable because the *range* of just and reasonable results must encompass the existing rates.

Second, it is important to understand that the economic issues that surround TELRIC pricing are, for the most part, unrelated to how the prices for local switching and transport have been established. The principal RBOC objection to TELRIC pricing is the claim that it is not "…rooted in the real-world attributes of the existing network, rather than the speculative attributes of a purely hypothetical network."[22] However, this concern principally relates to how certain *loop* charges are estimated, not the rates for local switching or transport.[23] For instance, the "actual network topology" is already a feature of the TELRIC process for local switching because the number of wire centers (and, therefore, the number and location of switches) is fixed in the TELRIC model.

This view – that the TELRIC rules do not impact how switching and transport costs are calculated – is shared by at least one RBOC. BellSouth has testified to very same point:

> It is important to note that even though the fundamental cost methodologies (i.e., TSLRIC and TELRIC methodologies are similar … it is the additional constraints currently mandated by the FCC that the incumbent local exchange carriers (ILECs) object to with respect to TELRIC-based rates. The use of a hypothetical network and most efficient, least-cost provider requirements have distorted the TELRIC results and normally understate the true forward-looking costs of the ILEC.
>
> These distortions, however, are most evident in the calculation of unbundled loop elements, and they are less evident in the switching and transport network elements that make up switched access.[24]

Both because the FCC's TELRIC rules "must produce rates that are just, reasonable and nondiscriminatory"[25] -- and because the more controversial aspects of the TELRIC methodology do not generally apply to how switching and transport costs are calculated -- state commissions should not expect that a "just and reasonable rate" for section 271 elements should depart significantly from the existing TELRIC-based rate.

Finally, state commissions must assure that the incumbents do not impose discriminatory policies affecting the entrants' ability to use combinations of (or combine) UNEs obtained under section 271 with UNEs obtained under section 251 (sometimes called 'commingling.")[26] The

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[22] See, *Notice of Proposed Rulemaking*, WC Docket 03-173, September 15, 2003 ("*TELRIC NPRM*"), ¶ 4.

[23] By this statement, we do not agree with the claim that the FCC's TELRIC rules understate relevant loop costs; rather, our point is that the claim itself does not generally even *apply* to switching, irrespective of its merit.

[24] Direct Testimony on Robert McKnight on behalf of BellSouth, Public Service Commission of South Carolina (McKnight Direct), Docket No. 1977-239-C, filed December 31, 2003, pages 7, 9.

[25] *TELRIC NPRM*, ¶ 4.

[26] When section 251 UNEs are combined with other elements (such as section 271 UNEs or tariffed services), these elements are referred to as "commingled." (TRO ¶ 597, emphasis added):

nation has once experienced efforts by incumbent LECs to impose discriminatory operational processes (such as unnecessary collocation requirements or threats of circuit sabotage) to disrupt the competitive process in ways that the Supreme Court has reasoned are anticompetitive.[27] We remind state commissions of RBOC reactions to the temporary uncertainty created when the Eighth Circuit (in an action later reversed by the Supreme Court) vacated the FCC's rules relating to combinations. We fully expect that the RBOCs will propose similar abuses here and state commissions will need to take corrective actions as they arbitrate the RBOC's nondiscrimination obligations under section 271.

## Conclusion

The current uncertainty as to the intent and obligations of section 251 can be greatly reduced by state commissions acting immediately to fill the gap, clearly defining the RBOCs' parallel obligations under section 271 to offer the most critical elements to local competition – loops, transport, switching and signaling. The time is now to begin that process.

In the interim, RBOCs should be required to continue to offer each of the network elements required by section 271 of the Act at existing (which is to say, cost-based) rates as such rates are the only rates found to be just and reasonable. While other rates may also satisfy the potentially more liberal "just and reasonable" standard that has traditionally been used in establishing regulated rates, until state commissions have an opportunity to review such proposals, the RBOCs should not be permitted to impose unilateral increases on competitors.

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> By commingling, we mean the connecting, attaching, or otherwise linking of a UNE, or a UNE combination, to one or more facilities or services that a requesting carrier has obtained at wholesale from an incumbent LEC pursuant to <u>any</u> method other than unbundling under section 251(c)(3) of the Act, or the combining of a UNE or UNE combination with one or more such wholesale services.

[27] As the Supreme Court concluded in Iowa [CITE], preventing the ILEC from sabotaging combinations is justified as "…ensuring against an anticompetitive practice."

# Exhibit 5

# “Baby Bells See Rivals Taking Fewer Phones”
# Reuters Article

**Financial News**



Reuters

# Baby Bells See Rivals Taking Fewer Phones

Thursday September 9, 12:48 pm ET

By Justin Hyde

WASHINGTON (Reuters) - Three of the nation's dominant local telephone companies said on Thursday that they had seen a sharp drop-off in new residential lines leased to competitors since AT&T Corp. (NYSE:T - News) announced a retreat from residential service in July due to changing federal rules.



The three Baby Bells -- Verizon Communications Inc. (NYSE:VZ - News), BellSouth Corp. (NYSE:BLS - News) and Qwest Communications International Inc. (NYSE:Q - News) -- also said they had seen little change in the total number of customers served by lines leased to competitors. But Verizon and BellSouth said they were optimistic about how many customers they could get back over the next few years.

"At the end of the day I think we'll get the bulk of those customers back," said BellSouth Chief Financial Officer Ron Dykes at a Morgan Stanley investment conference in Washington.

AT&T has said its decision to stop marketing its residential services stemmed from changes earlier this year in federal rules governing how much the Baby Bells can charge competitors to lease the copper wires running into homes.

AT&T and other competitors such as MCI Inc. (NasdaqNM:MCIP - News) contended those changes would lead to price hikes from the Baby Bells and make reselling lines too expensive. MCI has said it would consider cutting back on residential marketing in some regions, but has not specified the scope of any cuts.

Industry executives and analysts have said due to the rule changes, the Baby Bells could recapture most of the 17 million local lines that competitors now lease under federal rules, boosting earnings.

Verizon Chief Financial Officer Doreen Toben told the Morgan Stanley conference that Verizon has seen "a marked decrease in amount of new (competitor-leased) lines,

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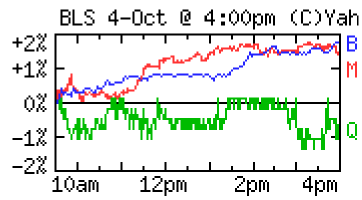


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especially residential," from AT&T and MCI.

"That said, we do have a base of about six million (leased lines) where we've yet to see any reduction in absolute numbers," she said.

Qwest Chairman and Chief Executive Richard Notebaert said at the same conference that Qwest had seen a roughly 50 percent drop last month in new residential lines leased to competitors over the previous month.

Morgan Stanley's Dykes said BellSouth had also seen an impact "from AT&T, with their visible withdrawal, as well as MCI with their less visible withdrawal."

AT&T's retreat from residential phone services put the dominant local phone companies on the attack and gave their lagging stocks a jolt of popularity among investors and analysts. The Bells have long maintained that the federal-set rates for leasing lines to competitors were below their costs, and Bell executives have said every residential telephone line they get back from a competitor adds roughly $20 per month to profits.

Toben said Verizon was having an internal debate about how many of the roughly 3.6 million residential lines leased by its competitors it might be able to eventually win back over the next several years, with some estimates running as high as 80 percent.

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# Exhibit 6

# “The Truth About RBOC UNE-P Costs”
# CompTel/ASCENT Whitepaper

# Wholesale Lies: The Truth About RBOC UNE-P Costs

**May 21, 2003**

# Wholesale Lies: The Truth About RBOC UNE-P Costs

During the public debate over the Federal Communications Commission's (FCC) Triennial UNE Review, a key point of disagreement was the economics of the wholesale leasing of so-called unbundled network element platform (UNE-P) network access by the Regional Bell Operating Companies (RBOCs) to competitive local exchange carriers (CLECs). The debate will continue throughout 2003, as state utility commissions conduct a series of reviews required by the FCC in its Feb. 20, 2003 decision to retain UNE-P leasing requirements.

Stung by the loss of local service customers to competitive carriers, the RBOCs had pressed the FCC to restrict CLEC access to UNE-P lines. The Bells complained that state utility commissions were setting wholesale rates at "below-cost" levels that caused them to lose money on every UNE-P line, jeopardizing their long-term financial well being.

CLECs countered that state commissions have done what was required of them: set UNE prices based on their cost, and observed that UNE-P remained essential to competition and that limiting access or raising the UNE-P rates would destroy their ability to offer affordable service. Both CLECs and state utility commissioners said the rate-setting process promoted consumer choices and reduced prices to consumers,[1] while also allowing the Bells to earn a reasonable profit. The current pricing system was upheld by the U.S. Supreme Court in May 2002.

Drawing upon a number of independent analyses, this paper concludes that the RBOCs earn healthy margins on their wholesale UNE-P business, even when accounting for the "embedded" cost of constructing and maintaining the existing phone networks. In fact, they were collectively enjoying an annual rate of profits of at least $605 million on their UNE-P leases as the first quarter of 2003 drew to a close. The profit number grows daily with the addition of UNE-P lines. With each new line, the total revenue, and the profit, goes up. There is a relatively wide variation in margins among the operating companies from about 16% for Verizon to more than 33% for Qwest. But in the aggregate, UNE-P leasing produces a positive return for the Bells.

UNE-P margins may be smaller than what the Bells earn from exerting their monopoly power and servicing lines at retail, but the data refutes the assertion that UNE-P is a money loser. From a bottom line standpoint, moreover, UNE-P leasing is better for the Bells than a system in which CLECs serve customers with their own facilities, which provides the RBOCs with zero dollars in leasing revenues.

## BACKGROUND

In an effort to introduce competition into the market for local phone service, the Telecommunications Act of 1996 required the RBOCs to make their networks available to new market entrants for the delivery of competitive service to homes and businesses. Recognizing that no new entrant would have the capital to construct its own network and run

[1] A CompTel study issued in January 2003 estimated that a fully competitive environment in every state could save Americans $9.2 billion on phone bills annually.

wire to every customer, Congress directed the FCC to develop a regime for sharing the existing network.

Adopting the strategy that facilitated competition in the long-distance marketplace, the FCC ordered the RBOCs to make available the entire network platform (UNE-P), which included all the essential elements – the wire, network interfaces, local circuit switching, transport and signaling and call-related databases among others – at a cost-based price to be determined by state public utility commissions.

Until 2001, however, the number of UNE-P lines leased by CLECs was relatively small. The slow development of UNE-P leasing is largely attributable to two factors: the above-cost wholesale prices established by the states were simply too high to allow CLECs to earn a profit and the RBOCs had not yet fulfilled their obligations from the Telecom Act to introduce operations support systems (OSS) that would enable competitors to interconnect efficiently with their networks. In the past few years, however, these OSS have been introduced and many state commissions began to lower wholesale rates under the TELRIC (Total Element Long Run Incremental Cost) method established by FCC in 1996 to guide the states in setting rates.

TELRIC, the only cost measure that utility commissions may consider, enables recovery of the RBOCs "forward-looking," costs, i.e. the expenses of building and operating an efficient network to provide lines and other infrastructure. In addition, TELRIC provides for a "reasonable" profit included in these costs. TELRIC does not cover "embedded costs," which would include such items as network assets acquired in earlier years. In establishing TELRIC, the FCC concluded that prices based on embedded costs were inappropriate because the Telecom Act says that prices cannot be determined with reference to rate of return regulation, which practically guarantees a profit whatever the company's cost. Embedded costs are closely tied to rate of return regulation.

TELRIC has received the blessing of the U.S. Supreme Court, which in a May 2002 decision rejected a Bell company challenge. The Court called the state rate-setting process "smooth-running affairs" and said that the Bell's proposed embedded-cost pricing method would enable the RBOCS to saddle consumers with inefficiencies "caused by poor management . . . or poor investment strategies."[2]

The reduction in UNE-P rates and improvement in OSS triggered a steep rise in the use of UNE-P (Figure 1). From just 489,000 at the end of 1999, the number of UNE-P lines served by CLECs climbed to 2.8 million in December 2000 to nearly 5.8 million at the close of 2001 and roughly 10.2 million by December 2002. Pending receipt of updated data from Qwest, the number of UNE-P lines totaled 11.6 million at the end of March 2003.

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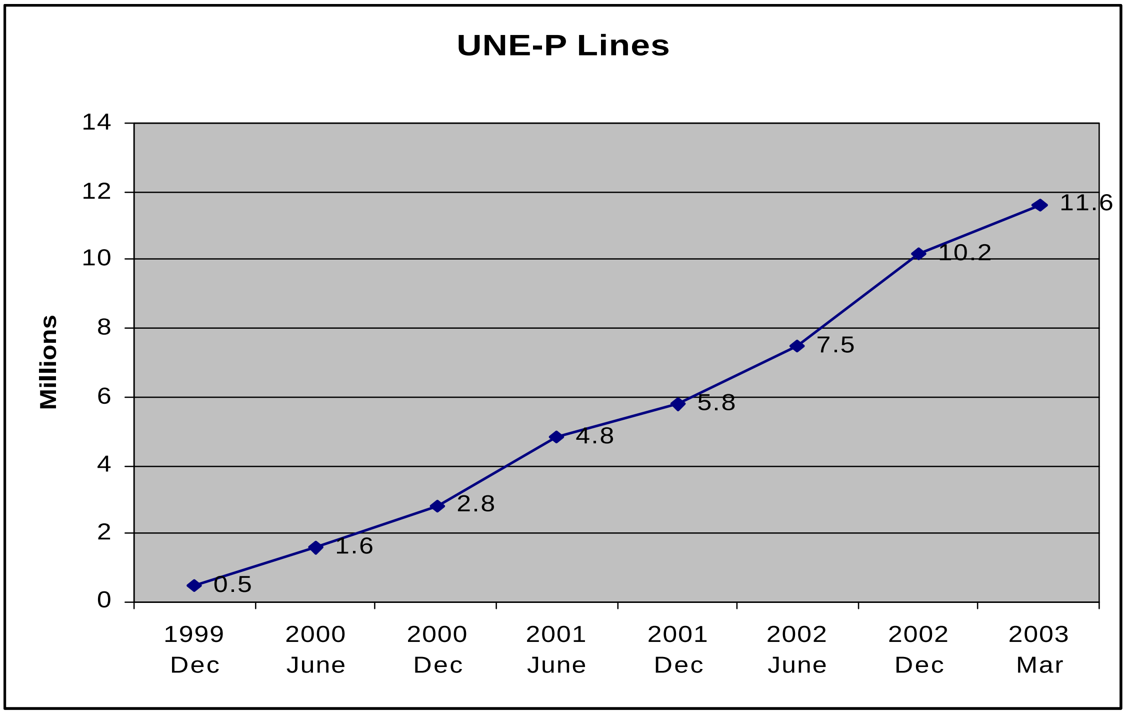
[2] U.S. Supreme Court ruling in *Verizon Communications Inc v. Federal Communications Commission*, May 13, 2002, p. 51 and p. 40, respectively.

Figure 1:




Source: FCC, "Local Telephone Competition: Status as of June 30, 2002;" later data from company reports

Amid the debate over UNE-P, the Bells were, for the first time, winning regulatory permission to enter the long-distance marketplace on a state-by-state basis once certain competitive benchmarks were achieved. By the end of 2002, the Bells were authorized to sell long-distance service to more than 70 percent of Americans and were collectively servicing about 17.5 million long-distance lines – mostly by leasing from the pre-existing LD companies, AT&T, MCI and Sprint.

## UNE-P MARGINS

Again, the RBOCs claim that they are forced to lease UNE-P at below-cost rates but do not support that assertion. This paper draws upon independent measures of costs and revenues to show that that assertion is not true, even if the RBOCs' preferred measure of costs, i.e., embedded, historical costs, is used to calculate the UNE-P margins. This paper in no way endorses embedded costs, but simply uses it as a benchmark to show that the RBOCs' wholesale business is, and can be, profitable by any reasonable measure.

Several recent studies have examined the issue of UNE-P costs and revenues in an attempt to resolve the debate over the impact of UNE-P on RBOC finances. Key to any conclusion on margins is determining the cost to the Bells of providing UNE-P service. Existing analyses take somewhat different approaches to this question.

As noted, a set of wholesale rates has been established by the individual state utility commissions based on TELRIC's method, Bell company data, and public evidentiary hearings involved in the rate-setting process.

Moreover, ARMIS (Automated Reporting Management Information System) data provided to the FCC contains detailed expense and investment information to enable an independent calculation of RBOC embedded costs – the historical costs to the RBOCs of putting existing infrastructure in place. The recent study by economists Randolph Beard, George S. Ford and Christopher Klein (BFK)[3] calculates the embedded costs per line from the ARMIS data and includes a calculation of capital expenses. The BFK approach takes the elements that the RBOCs say represent the costs they actually incur and does so with sufficient detail and clarity that their estimates are reproducable using the publicly-available ARMIS data. This method generates numbers that provide somewhat higher costs than the forward-looking costs allowed under the TELRIC methodology, effectively testing the Bell assertions of "below-cost" UNE-P rates on their own terms.

Some analyses by Wall Street investment firms calculated embedded costs per line to be higher than those calculated by BFK. But, in our view, BFK performed the most reasoned analysis, which was sensitive to, and forthcoming about, the potential pitfalls involved. For example, BFK directly addressed issues associated with avoided retail costs and allocation of costs to switched access lines. BFK's cost estimates include all the ARMIS data for "plant specific" expenses, but it eliminates some "plant non-specific" expenses to exclude a portion of costs for such items as artwork, furniture and general computers.

In contrast, some Wall Street analysts simply assumed current retail revenue per line represented a break-even level for the RBOCs with respect to embedded cost, and therefore, equals embedded cost per line. Others tackle embedded costs somewhat more directly, but do not sufficiently account for retail costs that would be avoided and have over-allocations of cost to switched lines as opposed to special access lines. Each of these flaws overstates embedded costs applicable to wholesale switched access lines. Furthermore, the Wall Street analysts do not concern themselves with capital costs at all, while BFK does so in a fairly sophisticated way.

In determining margins, BFK uses other independent calculations of the amount of revenue that RBOCs are expected to bring in for selling each UNE-P line. These calculations, dependent upon UNE rates in the states and usage assumptions per line, were performed by analysts at a few investment banking firms and by Z-Tel in a letter to the FCC. For comparison with costs and to be conservative, this paper uses the middle-range of those UNE-P revenue calculations, which were done by Commerce Capital Markets (CCM)[4], adjusted for access line counts in ARMIS for consistency and for "non-recurring cost" revenue brought in for customer change orders.[5]

[3] "The Financial Implications of the UNE-Platform: A Review of the Evidence," by T. Randolph Beard, George S. Ford, Christopher Klein, *Commlaw Conspectus* (forthcoming), and available at Telepolicy.com, May 2003

[4] "Status & Implications of UNE-Platform in Regional Bell Markets," Commerce Capital Markets, November 12, 2002.

[5] See, *BFK*, pp. 9-14.

While identifying significant variation among the RBOCs, the per-line data demonstrate that each of the Bell companies makes money in the wholesale business of leasing UNE-P lines (Figure 2), even using the embedded-cost measure. The embedded cost per month of providing the lines ranges from $15.97 for SBC to $19.64 for BellSouth, while wholesale margins range from $3.48 for Verizon to $8.72 for Qwest. The average per line wholesale margin for all the RBOCs is $4.80, or an average return on UNE-P revenue of 21.6 percent.

SBC, the largest provider of UNE-P lines, receives the smallest amount of gross revenue per line. Because of lower wholesale rates in several of the low-cost states it serves, its per line revenue totals $19.94, compared to a high of $26.07 for Qwest. This may explain the relative vehemence of SBC's objection to the UNE-P system, but even with lower per line charges, SBC still earns $3.97 per line – a profit margin of nearly 20 percent.

**Figure 2 – Revenue Data**

| Company | Monthly Revenue per line | Monthly Expense per line | Monthly Net Margin | Return as % of revenue |
|---|---|---|---|---|
| BellSouth | $25.64 | $19.64 | $6.00 | 23.4 percent |
| Qwest | $26.07 | $17.35 | $8.72 | 33.4 percent |
| SBC | $19.94 | $15.97 | $3.97 | 19.9 percent |
| Verizon | $21.54 | $18.06 | $3.48 | 16.2 percent |
| **All RBOCs** | **$22.22** | **$17.42** | **$4.80** | **21.6 percent** |

*Note: "All RBOCs" data represents a weighted average. The cost data are from BFK, footnote 3, above. The revenue data are from CCM, footnote 4, above, and reported by BFK and as adjusted by BFK (See note 5, supra).*

## UNE-P PROFITS

While selling UNE-P at wholesale may be less profitable than direct retail sales to customers, wholesale is a profitable business for the RBOCs. At the end of the first quarter of 2003, the RBOCs were earning annual profits of at least $605 million on more than 11.6 million UNE-P lines they were providing to competitors (Figure 3). This profit grows daily as the number of UNE-P lines leased to competitors rises.

SBC has almost half of those lines.[6] With an annual profit of $47.64 per line, that results in an annual profit of $275 million.

Verizon, the second largest provider of UNE-P lines, was earning some $149 million annually on its 3.57 million UNE-P lines.

[6] In its quarterly report for the fourth quarter of 2002, SBC said it was providing "more than 5 million" UNE-P lines at year end, an increase of 810,000 from the preceding three-month period when it reported that it was providing about 4.2 million UNE-P lines. In its first quarter 2003 report, it says that UNE-P lines grew by an additional 770,000 lines, and this totals to 5.78 million.

BellSouth was providing some 1.8 million UNE-P lines at the end of 2002. With a monthly per line margin of $8.72 that translates to net annual earnings of nearly $130 million.

Qwest was providing 490,000 UNE-P lines at the close of 2002, the latest date for which data were available as this report was being prepared, for an annual profit of slightly more than $51 million.[7]

**Figure 3 – UNE-P Earnings Data**

| Company | UNE-P Lines AS OF 1st Q '03* | Monthly Per Line Margin | Annual Per Line Margin | Annual Total Rate of Profit |
|---|---|---|---|---|
| BellSouth | 1.80 million | $6.00 | $72 | $130 million |
| Qwest | 490,000 | $8.72 | $104.64 | $51 million |
| SBC | 5.78 million | $3.97 | $47.64 | $275 million |
| Verizon | 3.57 million | $3.48 | $41.76 | $149 million |
| **All RBOCs** | **11.63 million** | **$4.80** | **$57.60** | **$605 million** |

*Note: "All RBOCs" margins are a weighted average. The All RBOCs profit is the sum of the individual company totals.*
** Except for Qwest, UNE-P lines data is for 1Q2003. Qwest lines are for 4Q02, because 1Q03 data were not yet available.*

## BELL FINANCES

While the data show that UNE-P generates profits for the RBOCs, it remains important to recognize that UNE-P accounts for just a small portion of the Bell's business and is not a make-or-break proposition for any of the companies. It also is important to recall that by facilitating competition, UNE-P has provided the opportunity for the Bells to enter the long distance market, among the Bells fastest areas of growth and a significant source of new revenue and earnings. Any loss from the shift of RBOC business from retail to wholesale because of UNE-P will be more than offset by gains in long distance.

By the end of 2002, Verizon had become the nation's third largest long-distance company. It reported long-distance revenue of $3.1 billion dollars and said it was serving 10.4 million long-distance customers, a 40 percent increase from 7.4 million at the end of 2001. At the end of March 2003, it had 13.2 million long-distance customers. SBC reported a 25 percent increase to 6.1 million in long-distance lines and said it took in $2.3 billion in total revenues on long distance as 2002 closed. SBC is looking to gain significant market share in California where it was permitted into the market in the final weeks of 2002. By the end of March 2003, it already had 7.6 million lines. In December 2002, BellSouth became the first Bell company to gain permission to market long-distance services in every state in its region and was serving about 1 million long-distance customers as the year closed. By the end of March, the company had 1.9 million long-distance customers. BellSouth reported

[7] The number of UNE-P lines for each of the RBOCs were obtained from the companies' investor briefings for the first quarter of 2003 and, for Qwest, the fourth quarter of 2002.

$883 million in long distance revenues in 2002. The Bells are generally predicting that they will achieve long-distance market share of 60 percent or more in every state.

Verizon, for example, reported operating income of nearly $15 billion on total revenues of $67.6 billion for 2002. The company's estimated $149 million annual UNE-P profits, thus equals nearly 1 percent of its total earnings. For SBC, UNE-P profits represented about 3.2 percent of its $8.6 billion in annual operating income. BellSouth's annual UNE-P profits were equal to about 2.7 percent of its annual $4.9 billion in operating income.

With total 2002 revenues ranging from $22.4 billion for BellSouth to $67.6 billion for Verizon, these three companies remained among America's 100 largest corporations. Despite growing challenges, they remain extraordinarily profitable.

Qwest reported significant losses as a result of a variety of well-documented problems, despite having nearly $15.5 billion in annual revenues. UNE-P profits, while beneficial, are not a significant factor in its overall financial circumstance.

# Exhibit 7

## SBC News Bulletin

SBC NEWS BULLETIN!

SPECIAL OPPORTUNITIES FOR RETURNING CUSTOMERS ONLY!

*******AUTO** 5-DIGIT 48306

Dear David

Having you return to SBC Michigan is so important to us we've come up with some brand new offers and rates that we feel are pretty remarkable.

Like "Free", for instance. As in FREE SBC Long Distance for returning customers!

This brand new plan gives you 30 FREE long distance minutes per month for 6 months. After 30 minutes, it's only 5¢ per minute.

**Save money on our lowest local rate ever!**

While "Free" is as good as it gets, our new UNLIMITED local rate of $7.95 per month adds up to even more savings for returning customers.

Regularly priced at $17.95 per month, we will give you a bill credit of $10 per month, which reduces your monthly rate to only $7.95 per month for five months. This money-saving UNLIMITED local calling plan also includes our most popular calling features listed at the right.

We have other local and long distance plans that you also might want to consider.

(over, please)

# FREE
## Long Distance

For 6 months*

- 30 minutes of FREE SBC Nationwide Long Distance per month
- Only 5¢ per minute after the first 30 minutes
- No monthly fee
  (with JustCall℠ 7 Cents Preferred from SBC Long Distance)

# UNLIMITED
## Local Calling†

**$7.95** per month

for the first 5 months**

ALSO INCLUDES:

- Caller ID with Name
- Call Waiting
- LINE-BACKER®

**RECONNECT WITH THE BEST– FOR LESS!**

CALL **1-888-407-3960** TODAY! **HURRY!** OFFER EXPIRES SOON.

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